

UNIVERSITY OF EAST ANGLIA

**NON-EXECUTIVE DIRECTORS' SELF-INTEREST:
FIDUCIARY DUTIES AND CORPORATE
GOVERNANCE**

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ABSTRACT

The board of directors at a company usually comprises both executive and non-executive directors. Their role is to run and direct the company for its benefit since it is incapable of acting by itself. Where there is a separation of ownership and control it is recognised that there is a risk that those in control may use their power for self-interested means. Attention is often focused on the executive directors and how legal controls and governance mechanisms can reduce the possibility of self-interest in the performance of their functions. However, seldom are non-executives the focus of this problem yet they are playing an increasingly important role in the running and governance of the company.

This thesis is an investigation in to whether the legal rules and governance mechanisms are suitable in reducing the possibility of self-interest amongst non-executive directors. The study uses multiple directorships as a proxy for non-executive self-interest to demonstrate whether the controls and incentives are suitable. It begins by examining the nature of a non-executive's fiduciary liability to the company focusing on the nature and purpose of the duty to identify when and why the duty is owed. Identifying the nature and purpose of the duty will allow the thesis to demonstrate that existing authority and academic literature on the scope of a non-executive's fiduciary duty is an unsuitable interpretation based on the company's current objects and reanalyses it from the perspective of the non-executive's undertaking on the board. Whilst the analysis concludes that this interpretation would offer a suitable scope in deterring self-interest the thesis continues by examining the enforcement of fiduciary duties by considering the new statutory derivative claim. This analysis reveals that enforcement is low and may reduce the deterrence the fiduciary duties themselves might have. With low levels of enforcement the thesis turns its attention to *ex ante* incentives, particularly corporate governance mechanisms, which can "nudge" the non-executive in to acting for the benefit of the firm. This analysis contains a review of the corporate governance

theories and an empirical study to identify the ways non-executive self-interest may be reduced. The theoretical analysis considers the ways boards may be structured to reduce the potential for self-interested behaviour. Using multiple directorships as a proxy for self-interest the empirical analysis provides evidence as to whether they are in fact perquisite consumption and identifies possible means of control. It is considered herein that there are insufficient controls and incentives on non-executive behaviour, which may lead to increased self-interest to the detriment of the company.

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Chapter I

Introduction

Restrictive provisions which may have the effect of either curtailing the facilities for the formation of companies which bring so much business to England, or of embarrassing the administration, or deterring the best class of men from becoming directors, are not to be lightly entertained.¹

I. ORIGINAL CONTRIBUTIONS TO THE LITERATURE

After the economic crisis of 2008 questions have been asked about governance in companies and a lot of critical attention has been focused on shareholders and their control rights in the company. For example, the Enterprise and Regulatory Reform Act 2013 has given shareholders a greater say over executive remuneration whilst academic insight has also suggested greater power for shareholders may increase firm value.² Equally, academic literature often considers how the governance in a firm influences the executives or firm performance.³ Often focus is on whether they are suitably controlled and incentivised to act for the benefit of the company at the expense of their own self-interest since they are a market induced mechanism to run the company for its benefit.⁴ However, seldom is focus placed on the non-executives, appointed, in theory, to monitor executive management since

¹ Report of Lord Davey's Committee, 1895, p.VI; M Barlow, 'The New Companies Act, 1900' (1901) 11(42) *The Economic Journal* 180, 181

² L Bebchuk, 'The case for increasing shareholder power' (2005) 118 *Harvard Law Review* 833

³ See, for example, C Ingley and N van der Walt, 'Do Board Processes Influence Director and Board Performance? Statutory and performance implications' (2005) 13(5) *Corporate Governance: An International Review* 632; G Nicholson and G Kiel, 'Can Directors Impact Performance? A case-based test of three theories of corporate governance' (2007) 15(4) *Corporate Governance: An International Review* 585

⁴ E Fama, 'Agency Problems and the Theory of the Firm' (1980) 88(2) *Journal of Political Economy* 288, 293

the executives and shareholders lack the proper incentives to monitor themselves.⁵ Yet with their increased role within the company⁶ greater attention needs to be placed on these individuals. If the controls and incentives for non-executive directors are not properly considered these individuals may advance their own self-interest ahead of the company's interests potentially leading to weaker governance. Using multiple directorships⁷ as a proxy for non-executive self-interest, this thesis seeks to examine whether the legal rules and corporate governance mechanisms are suitable for controlling and incentivising non-executive directors to act for the benefit of the company.

Specific contributions of this work begin with the analysis of a non-executive director's fiduciary duty of loyalty. This thesis does not intend to examine other duties owed by non-executive directors such as best interests or duty of care as these duties are wider than the fiduciary duty, which is specifically focused on reducing the possibility of self-interest by requiring the fiduciary to be loyal.⁸ The work offers an alternative approach to fiduciary duties albeit not a radical departure from respected academic insight from Flannigan,⁹

⁵ E Fama, 'Agency Problems and the Theory of the Firm' (1980) 88(2) *Journal of Political Economy* 288, 295;

⁶ See, for example, *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [83]; citing J Gower, *Principles of Modern Company Law*, (6th edn Sweet & Maxwell, 1997) 622; The Higgs Report, *Review of the role and effectiveness of non-executive directors*, (January, 2003) para 1.6; The Walker Review, *A review of corporate governance in UK banks and other financial industry entities*, (November, 2009) para 2.7-8 (hereinafter Walker Review)

⁷ Here multiple directorships are considered to be where a non-executive holds multiple appointments on boards of directors concurrently

⁸ See, for example, *Bristol and West Building Society v Mothew* [1998] Ch. 1, 18; M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010); R Flannigan, 'Fiduciary duties of shareholders and directors' (2004) *Journal of Business Law* 277

⁹ R Flannigan, 'The Boundaries of Fiduciary Accountability' (2004) *New Zealand Law Review* 215; R Flannigan, 'Access or Expectation: The test for fiduciary accountability' (2010) 89(1) *The Canadian Bar Review* 1

Conaglen,¹⁰ Finn¹¹ and Edelman.¹² Whilst not critical to the work as it is appreciated that directors, executive and non-executive, owe fiduciary duties,¹³ the analysis seeks to establish when and why the duty is owed in Chapter II so as to establish in Chapter III the exact scope of a non-executive's fiduciary duty to demonstrate whether it is suitable in controlling their self-interest. The analysis in these two chapters offers two main insights that first, the duty is owed by the fiduciary purely on the basis of granting that individual access to the principal's property and/or affairs for the latter's unilateral benefit. Only in these situations can one be expected to act loyal to a principal since if they have not agreed to remove self-interest then there can be no complaint if they choose to do so. Arguments offered by Edelman that the duty is owed based on reasonable expectations or a degree of vulnerability in a relationship does not clearly appreciate that the purpose is to remove self-interest from such relationships and would not be able to clearly identify those situations where the duty is owed in every case. Second, appreciating that the duty is designed to remove self-interest from the relationship the chapter aims to clarify the scope of a non-executive's fiduciary duty, which could equally be applied to executive directors. Whilst other authors such as Lim¹⁴ and Kershaw¹⁵ have sought to identify the scope of a director's fiduciary duty by focusing on what the company's current objects are, or scope of business is, this analysis looks at the scope from the other end of the perspective by focusing on what the director undertakes responsibility for. It identifies that the duty is circumscribed, not by what the company does, but what the director undertakes responsibility for. This offers a more satisfactory analysis in

¹⁰ M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010)

¹¹ P Finn, *Fiduciary Obligations* (Law Book Company, 1977)

¹² J Edelman, 'When do fiduciary duties arise?' (2010) 126 LQR 302

¹³ Companies Act 2006, s. 170; *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822; *Boardman v Phipps* [1967] 2 A.C. 46

¹⁴ E Lim, 'Directors' fiduciary duties – A new analytical framework' (2013) 129 LQR 242

¹⁵ D Kershaw, 'Does it matter how the law thinks about corporate opportunities?' (2005) 25(4) LS 533

determining director loyalty since it appreciates the purpose of the duty being owed is to prevent self-interest in a fiduciary relationship. If one focuses their analysis as to the scope of what the principal does, rather than what the fiduciary takes responsibility for there is a danger of the scope being too narrow, or too wide potentially, since it may not cover everything the fiduciary takes responsibility for, leaving them to act with self-interest to the detriment of the principal. This is particularly pertinent to appreciate in a director context since a company is capable of doing anything, therefore limiting the scope of the duty to what the company's scope of business is would not adequately control self-interest amongst non-executives.

Using existing theoretical and empirical literature on corporate governance, a particularly significant contribution of this work is how governance mechanisms may be used to incentivise individuals. Theoretical literature is considered to give unique insight as to how a non-executive may be incentivised to act for the benefit of the company. It is considered that whilst no one theory may explain the nature of every individual, each one offers valuable insight in to how one may be incentivised and the chapter considers the risks associated with one theory compared to the others. From this the thesis offers an empirical analysis in to what influences, and may be used to control, non-executive self-interest. Several hypotheses have been formulated from the existing literature to consider this and multiple directorships are used as an outcome variable in this study as they are considered to be a potential form of perquisite consumption.¹⁶ Using predictors such as remuneration and equity the analysis will demonstrate whether there are governance mechanisms that may be used to control self-interest. Results from the study have demonstrated that where remuneration is greater, non-executives hold more appointments. As well, where there is a greater concentration of agency problems in the firm this also predicts a greater amount of multiple

¹⁶ S Ferris, M Jagannathan and A Pritchard, 'Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments' (2003) 58(3) *The Journal of Finance* 1087, 1097

appointments amongst the non-executives. Whilst the evidence does show equity ownership significantly reduces the amount of external positions held, the multi-level study found that the significance was only higher pre-2008 than the significance of remuneration on non-executive appointments, and whilst the latter remained fairly constant after 2008 the impact equity had reduced. A correlation was also observed between agency problems and equity ownership, suggesting further that equity may not be a suitable control on non-executive self-interest. These results offer evidence that there may be a lack of suitable governance controls in preventing non-executive self-interest.

Finally this thesis fits together in a unique way by combining both the *ex post* fiduciary controls and *ex ante* governance incentives to demonstrate whether there are suitable mechanisms in place to reduce non-executive self-interest. The link between the fiduciary controls and governance incentives is made through the enforcement chapter. This chapter identifies that fiduciary duties are rarely enforced against directors, particularly non-executives, and considers whether the new statutory derivative claim¹⁷ will offer a suitable mechanism to allow the enforcement of loyalty against non-executives. On conclusion that enforcement is still unlikely, attention can turn to the *ex ante* incentives. Having considered the evidence the thesis argues that the fiduciary controls are suitable but the lack of enforcement may reduce the effect they have on deterring self-interest. Whilst non-executives may be incentivised there is a potential lack of governance mechanisms to reduce that possibility of self-interest. Therefore it is considered herein that the controls and incentives imposed to reduce self-interest amongst non-executives are not suitable, particularly if their responsibility within the company is to continue to increase.

¹⁷ Companies Act 2006, Part 11

II. NON-EXECUTIVE SELF-INTEREST IN MULTIPLE APPOINTMENTS

Non-executive directors have an important role on a company board. Yet their role and legal responsibilities are not always understood.¹⁸ In recent years their position on the board has become more involved.¹⁹ Additional responsibility means non-executives have increased access to the affairs of the company. This thesis sets out to examine how legal rules, in respect of fiduciary jurisdiction, and corporate governance mechanisms can increase the possibility that those who undertake responsibility as non-executive director will do so for the benefit of the company.

The company becomes a separate legal entity²⁰ upon incorporation.²¹ It can own property as well as having distinct rights and liabilities.²² However, it is an artificial entity and cannot act for its own benefit.²³ The judiciary has long recognised that individuals would occupy the position of director to run the company for its benefit²⁴ and the Companies Act 2006 requires public companies to have at least two directors and private companies to have at least one.²⁵ As a result, directors will control the company, but the company or shareholders collectively are owners. The separation of ownership and control identified by Berle and

¹⁸ See, for example, Hansard HL Vol 678, Official Report 6/2/06 Col GC288

¹⁹ See, for example, S Aris, 'Non-Executive Directors: Their changing role on UK boards' (1986) *Economist Intelligence Unit* Special Report no 244; Walker Review, (November, 2009)

²⁰ *Salomon v Salomon & Co Ltd* [1897] A.C. 22

²¹ Companies Act 2006, s. 15(1)

²² See, for example, *Gilford Motor Co Ltd v Horn* [1933] Ch. 935, CA; *Lee v Lee's Air Farming Ltd* [1961] A.C. 12, PC; *Chandler v Cape plc* [2012] EWCA Civ 525

²³ See, for example, R Sitkoff, 'The Economic Structure of Fiduciary Law' (2011) 91 B.U. L. Rev. 1039

²⁴ *Imperial Hydropathic Hotel Co Blackpool v Hampson* (1883) LR 23 Ch. D. 1; see also, C Noonan and S Watson, 'Examining company directors through the lens of de facto directorship' (2008) *Journal of Business Law* 587, 589

²⁵ Companies Act 2006, s. 154

Means' study of American corporations,²⁶ led Jensen and Meckling to theorise about an agency problem in corporations.²⁷ The study demonstrated that an agent, such as a director, acting for the benefit of a principal, such as the company, will inherently favour their own interests where it is more beneficial for them to do so than acting for the benefit of the company. Therefore legal rules and corporate governance structures are designed to reduce the possibility of self-interest where the interests of the company and director conflict so as to bring about an alignment.²⁸

In England, a board is made up of executive and non-executive directors to act for the company's benefit. The positions of executive and non-executive are not defined legal terms,²⁹ but terms of business that the courts recognise as the undertaking of different functions within the company.³⁰ Research and legal rules have long sought to devise ways to temper the self-regarding impulse of executive directors who are responsible for the day-to-day management of the company. Proscriptive legal rules such as the fiduciary duty of

²⁶ A Berle and G Means, *The Modern Corporation and Private Property*, (MacMillan, London 1932); This separation is also present in the UK see, for example, B Cheffins, 'Does Law Matter? The Separation of Ownership and Control in the United Kingdom' (2001) 30(2) *Journal of Legal Studies* 459; see also *Van Sandau v Moore* (1826) 1 Russ. 441 where there were 250 defendants who were shareholders and directors of the company

²⁷ M Jensen and W Meckling, 'Theory of the Firm: Managerial behaviour, agency costs and ownership structures' (1976) 3(4) *Journal of Financial Economics* 305; see also, K Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14(1) *Academy of Management Review* 57; E Fama and M Jensen, 'Separation of Ownership and Control' (1983) 26(2) *Journal of Law and Economics* 301

²⁸ M Jensen and W Meckling, 'Theory of the Firm: Managerial behaviour, agency costs and ownership structures' (1976) 3(4) *Journal of Financial Economics* 305, 307

²⁹ See Companies Act 2006, s. 250 for definition of "director"

³⁰ See, for example, *Equitable Life Assurance Society v Bowley* [2003] EWHC 2263 (comm); [2003] B.C.C. 829 at [41]; *Cambridge v Makin* [2011] EWHC 12 (QB) at [48]

loyalty³¹ that allows the principal to assess *ex post* whether the agent acted without self-interest is one of the ways this is achieved. The fiduciary duty of loyalty regulates self-interest strictly and the director would be liable to disgorge any personal profit where there is a conflict.³² Theory supports this approach as the duty replaces high contractual costs and impracticalities in trying to contract *ex ante* what the director should do to achieve the outcome desired.³³ Corporate governance structures also aim to incentivise *ex ante* what those legal rules deter *ex post*. Executives receive remuneration packages and are monitored to incentivise them to act for the benefit of the company.³⁴ One prominent way to deter self-interest is through the appointment of non-executive directors to monitor the executive management since shareholders themselves lack the incentives to monitor.³⁵

Whilst these mechanisms aim to reduce an executive's self-interest, seldom is attention given to whether fiduciary duties and governance structures are suitable for incentivising and deterring non-executive directors from self-interest. In 2003 the Higgs Report noted that the

³¹ See, for example, *Bristol and West Building Society v Mothew* [1998] Ch. 1; D Jensen, 'Prescription and Proscription in Fiduciary Obligations' (2010) 21 KLJ 333; F Easterbrook and D Fischel, 'Contract and Fiduciary Duty' (1993) 36(1 part 2) *Journal of Law and Economics* 425; R Sitkoff, 'The Economic Structure of Fiduciary Law' (2011) 91 B.U. L. Rev. 1039

³² Companies Act 2006, s. 175; *Boardman v Phipps* [1967] 2 A.C. 46; *Regal (Hastings) Ltd v Gulliver and Others* [1967] 2 A.C. 134; *Bhullar v Bhullar* [2003] EWCA Civ 424; [2003] B.C.C. 711

³³ See, R Sitkoff, 'The Economic Structure of Fiduciary Law' (2011) 91 B.U. L. Rev. 1039; F Easterbrook and D Fischel, 'Contract and Fiduciary Duty' (1993) 36(1 part 2) *Journal of Law and Economics* 425; R Goddard 'Enforcing the hypothetical bargain: sections 459-461 of Companies Act 1985' [1999] 20(3) *Company Lawyer* 66

³⁴ See, Financial Reporting Council (FRC), UK Corporate Governance Code 2010; E Fama, 'Agency Problems and the Theory of the Firm' (1980) 88(2) *Journal of Political Economy* 288;

³⁵ E Fama, 'Agency Problems and the Theory of the Firm' (1980) 88(2) *Journal of Political Economy* 288, 293; M Rix, 'Company Law: 1844 and To-day' (1945) 55 *The Economic Journal* 242, 257

role was still not understood,³⁶ whilst Baroness Noakes has also voiced concerns about non-executives where she observed that ‘the law on non-executive directors is potentially unclear and is certainly not tested to any great extent in the courts’.³⁷ Non-executives themselves have also shown concern as to what their liability may be.³⁸ Although Cheffins and Black contended that breaches of duty by non-executives are more likely to be that of duty of care rather than conflicts of interest,³⁹ this does not preclude the possibility of non-executives using their board influence to benefit him or herself.⁴⁰ Certainly the increased role that non-executives have on the board of a company, that goes beyond monitoring,⁴¹ as well as recent case law in *Cambridge v Makin*⁴² and *Mission Capital plc v Sinclair*⁴³ have shown the

³⁶ The Higgs Report, *Review of the role and effectiveness of non-executive directors*, (January, 2003) 3; see also, J Roberts, T McNulty and P Stiles, ‘Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom’ (2005) 16 *British Journal of Management* 5, 11

³⁷ Hansard HL Vol 678, Official Report 6/2/06 Col GC288

³⁸ D Anderson, S Melanson and J Maly, ‘The Evolution of Corporate Governance: power redistribution brings boards to life’ (2007) 15(5) *Corporate Governance: An International Review* 780, 788-9

³⁹ B Cheffins and B Black, ‘Outside Director Liability Across Countries’ (2006) 84 *Texas Law Review* 1385, 1405

⁴⁰ See, for example, *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [80]

⁴¹ See, for example, The Cadbury Report, *Report of the committee on the financial aspects of corporate governance*, (December, 1992) (hereinafter Cadbury Report), para 4.10; The Hampel Report, *Final Report: of the committee on corporate governance*, (January, 1998) (hereinafter Hampel Report), para 3.8; The Higgs Report, *Review of the role and effectiveness of non-executive directors*, (January, 2003) para 1.6; Walker Review, (November, 2009) para 2.7-8; UK Corporate Governance Code A.4; C Ingle and N van der Walt, ‘Do Board Processes Influence Director and Board Performance? Statutory and performance implications’ (2005) 13(5) *Corporate Governance: An International Review* 632, 642; D Anderson, S Melanson and J Maly, ‘The Evolution of Corporate Governance: power redistribution brings boards to life’ (2007) 15(5) *Corporate Governance: An International Review* 780; Standard Chartered plc, *Annual Report 2010*, 103; AstraZeneca plc, *Annual Report 2010*, 128

⁴² *Cambridge v Makin* [2011] EWHC 12 (QB) at [46]-[49], see also, N Sinclair, D Vogel, R Snowden, *Company Directors: Law and Liability Vol 1* (Sweet & Maxwell, 1997) para 3.56-7, 3.86

⁴³ *Mission Capital Plc v Sinclair* [2008] EWHC 1339 (Ch); [2008] B.C.C. 866

potential for non-executives to engage in conflicting behaviour. Standard Chartered's 2010 Annual Report provides anecdotal evidence of the non-executive's increased role: 'The increased fees, particularly for involvement in committees, reflect the growing regulatory and governance responsibilities, which require an increased time commitment from all non-executive directors.'⁴⁴ In *Mission Capital*, for example, it was alleged the non-executive directors used their power in a board meeting improperly to protect other business ventures they were involved in.⁴⁵ In *Cambridge* it was contended, although not decided upon, that a non-executive director had overseen the sale of data in the firm to an intermediary that they were privately interested in so as to obtain lucrative contracts.⁴⁶ There is an increased risk of self-interest as non-executives take up a more prominent role on the board and it needs to be considered whether the relevant controls are suitable for controlling the self-regarding impulse.

One way non-executives may act with self-interest is where they serve for multiple principals. In the managerial labour market⁴⁷ there is finite number of people able to serve as a director. As such, people capable of serving may take up multiple positions on different corporate boards. Directors will be in high demand for external positions as they have proven expertise that signals worth in the managerial labour market.⁴⁸ Multiple directorships are therefore seen to be a central feature of the "corporate governance landscape".⁴⁹

⁴⁴ Standard Chartered plc, *Annual Report 2009*, 103

⁴⁵ *Mission Capital Plc v Sinclair* [2008] EWHC 1339 (Ch); [2008] B.C.C. 866 at [5]

⁴⁶ *Cambridge v Makin* [2011] EWHC 12 (QB) at [7]-[8]

⁴⁷ E Fama and M Jensen, 'Separation of Ownership and Control' (1983) 26(2) *Journal of Law and Economics* 301

⁴⁸ E Fama and M Jensen, 'Separation of Ownership and Control' (1983) 26(2) *Journal of Law and Economics* 301, 315

⁴⁹ M Conyon and L Read, 'A model of the supply of executives for outside directorships' (2006) 12 *Journal of Corporate Finance* 645

Additional appointments are likely to be non-executive positions since this is generally a part-time role as opposed to the full-time role of the executive. Whilst these additional appointments may be a signal of worth and be for the benefit of the company⁵⁰ they may also be a form of perquisite consumption for the non-executive.⁵¹ Additional appointments may be taken on for the prestige or fees that are involved with holding such a position. This could lead to bad governance in any of the firms if the individual does not have the time or incentives to fulfil their functions.⁵² There is also the risk that once in that position the non-executive may advance the interests of one firm over the other where it is beneficial for them to do so.⁵³ Multiple appointments then provide some useful context to examine whether the mechanisms designed to control self-interest are suitable when applied to non-executives. The aim of this thesis is two-fold to examine whether the *ex post* deterrent of the fiduciary duty of loyalty and enforcement of it, and the *ex ante* incentives of corporate governance structures are suitable in aligning the non-executive's interests with the company's in the context of multiple appointments.

⁵⁰ See, for example, A Hillman and T Dalzell, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383; K Eisenhardt and C Schoonhoven, 'Resource-Based View of Strategic Alliance Formation: Strategic and Social Effects in Entrepreneurial Firms' (1996) 7(2) *Organization Science* 136; B Stone, 'Twitter, the Startup That Wouldn't Die' (Bloomberg Businessweek, 1st Mar 2012) <<http://www.businessweek.com/articles/2012-03-01/twitter-the-startup-that-wouldnt-die>> accessed 13th Mar 2012

⁵¹ See, for example, S Ferris, M Jagannathan and A Pritchard, 'Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments' (2003) 58(3) *The Journal of Finance* 1087, 1097

⁵² See, for example, L Bebchuk and J Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, (Harvard University Press, 2006); L Renneboog and Y Zhao, 'Us knows us in the UK: On director networks and CEO compensation' (2011) 17(4) *Journal of Corporate Finance* 1132

⁵³ See, for example, *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 B.C.L.C. 598

Recent *dicta* in *Cambridge* has created some uncertainty as to what extent non-executives owe the duty of loyalty. It was suggested that they might not be prevented from competing with the company:

[I]t does not appear that non-executive directors are prohibited from competing with the company or from taking directorships of competing companies. This stems from the difference in function between an executive and non-executive director. A non-executive director's role is usually limited to a supervisory one, effectively a policing function. By contrast executive directors actively manage its business.⁵⁴

If a non-executive is not prevented from competing against the company seemingly they would be able to act against the interests of their principal in another capacity. Chapter II shall begin an analysis of the fiduciary duty of loyalty owed by non-executive directors. This shall look at the purpose and standard of duty to determine how a non-executive is meant to act when owing a fiduciary duty of loyalty and why it is owed. Then it will be examined in what situations the non-executive will be required to be loyal to the company. This analysis will show whether a non-executive would be prevented from competing with the company and in what circumstances, to determine if the duty is a suitable means of deterring self-interest. To do this focus will be on the purpose of the duty and identify those situations where the purpose is fulfilled through an analysis of existing case law and academic opinion.

Chapter III shall then look at when this duty is breached, including post resignation breaches. Once it is determined that non-executives must be loyal to the interests of the company it must be considered what interests they must be loyal to. Recent case law from the Court of Appeal has suggested that a director must be loyal to all potential interests of the company.⁵⁵ Since company's can engage in any activity⁵⁶ and thus be interested in

⁵⁴ *Cambridge v Makin* [2011] EWHC 12 (QB) at [48]; citing N Sinclair, D Vogel, R Snowden, *Company Directors: Law and Liability Vol 1* (Sweet & Maxwell, 1997) para 3.56

⁵⁵ *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822

⁵⁶ Companies Act 2006, s. 31 *cf.* s. 7(2)

anything, this would seemingly prevent any self-interest a non-executive has. However, this seems an unlikely conclusion given that it would make multiple appointments untenable if a non-executive was required to be loyal to any potential interests of the company. It appears that there is a lack of understanding as to the extent a director, let alone a non-executive director, must be loyal to the interests of the company. This chapter will seek to explain the scope of the non-executive's loyalty to the company to show when they can and cannot act for another company's interests in multiple roles. To do so this chapter will look at the pre-existing case law on when someone is considered to be in a conflict of interest. Whilst a director's duty to avoid a conflict of interest is now codified in Section 175 of the Companies Act 2006 the purpose of the duty was to be a general statement of duties rather than a precise definition.⁵⁷ Therefore the Act's statement that someone will not be in conflict where it is not reasonable for it to be considered as such⁵⁸ requires analysis of the case law to consider what reasonable means in this context.

It should be noted that this chapter will be considering the duty of loyalty in respect of conflicts of interest only. It will not consider self-dealing transactions.⁵⁹ Self-dealing transactions are based on full disclosure and involvement with the company and it is its decision to enter in to the contract with one of its own, regardless of whether the individual director is interested. This is unlike conflicts of interest where the company can have no control over one of its director's pursuit of a competing interest at another company.

⁵⁷ Law Commission Report, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* (Law Comm No 261), (Cm 4436, 1999) (hereinafter Law Commission Report No 261 1999) paras 4.7, 4.11-13

⁵⁸ Companies Act 2006, s. 175(4); see also, *Bank of England v Vagliano Brothers* [1891] AC 107; Companies Act 2006, s. 170(3)(4); A Alcock, 'An accidental change to directors' duties?' (2009) 30(12) *Company Lawyer* 362

⁵⁹ See, Companies Act 2006, ss. 175(3), 177

Chapter IV shall progress to the principal's ability to assess the actions of the non-executive *ex post* through means of enforcement. Whether or not the analysis of Chapters II and III reveal the fiduciary duty of loyalty to be suitable in deterring self-interest of non-executives in multiple appointments, lack of viable enforcement of that duty could diminish any deterrent that it has.⁶⁰ This will be done by looking at the new statutory derivative claim that allows shareholders to litigate in the name of the company in respect of an action vested in it for, *inter alia*, breach of duty.⁶¹ It is recognised that before 2006 enforcement of duties against directors was rare, especially against non-executive directors.⁶² The purpose of this chapter is to analyse whether this new statutory procedure has created a more accessible means of enforcement for the company when a non-executive breaches their fiduciary duty compared to the old common law claim. However, this chapter does not seek to establish whether non-executives are more concerned about the presence of litigation after 2006.

Chapter V will look at *ex ante* incentives that could encourage non-executives to act for the benefit of the company. The chapter shall begin by identifying the potential benefits and detriments that multiple appointments may bring to the governance of a firm. Considering the governance effects multiple directorships can have, Chapter V shall take a theoretical

⁶⁰ See, for example, Z Zhang 'Legal Deterrence: the foundation of corporate governance – evidence from China' (2007) 15(5) *Corporate Governance: An International Review* 741; B Cheffins and B Black, 'Outside Director Liability Across Countries' (2006) 84 *Texas Law Review* 1385, 1387

⁶¹ Companies Act 2006, part 11

⁶² See, for example, J Armour *et al*, 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and United States' (2009) 6(4) *Journal of Empirical Legal Studies* 687; S Deakin and A Hughes, *Directors' Duties: Empirical Findings – Report to the Law Commissions* (ESRC Centre for Business Research, University of Cambridge 1999) (hereinafter ESRC Report); B Cheffins and B Black, 'Outside Director Liability Across Countries' (2006) 84 *Texas Law Review* 1385; H Hirt, 'The review of the role and effectiveness of non-executive directors: a critical assessment with particular reference to the German two-tier board system: Part 2' (2003) 14(8) *International Company and Commercial Law Review* 261; The Higgs Report, *Review of the role and effectiveness of non-executive directors*, (January, 2003)

perspective looking at how different corporate governance structures may motivate the non-executive to act for the benefit of the company. The chapter will look at the key corporate governance theories of agency,⁶³ stewardship⁶⁴ and resource dependence⁶⁵ to discuss how the non-executive may be incentivised through these structures to take additional appointments for the benefit of the company rather than for personal benefit. There will also be consideration of how the UK Corporate Governance Code recommends boards should be structured and how this recommendation correlates to incentivising non-executive directors. Focus is often placed on how the corporate governance of a company may be organised so as to reduce the possibility of conflict amongst executives. Considering how the structure might incentivise non-executives to perform the tasks expected of them for the benefit of the company will provide some unique insight to the functioning of the company. Whilst this chapter shall investigate ways to incentivise individuals, it does not intend to identify a “best-method” to incentivise non-executives. The purpose is to discuss the different theories and detail associated risks with such an approach according to the other theories considered.

Chapter VI provides empirical analysis on non-executives and multiple appointments to see whether there is evidence to support the notion that additional appointments are perquisite consumption and identify governance mechanisms that may control that consumption. The

⁶³ M Jensen and W Meckling, ‘Theory of the Firm: Managerial behaviour, agency costs and ownership structures’ (1976) 3(4) *Journal of Financial Economics* 305; K Eisenhardt, ‘Agency Theory: An Assessment and Review’ (1989) 14(1) *Academy of Management Review* 57

⁶⁴ J Davis, F Schoorman and L Donaldson, ‘Toward a Stewardship Theory of Management’ (1997) 22(1) *Academy of Management Review* 20; G Nicholson and G Kiel, ‘Can Directors Impact Performance? A case-based test of three theories of corporate governance’ (2007) 15(4) *Corporate Governance: An International Review* 585; J Roberts *et al*, ‘Beyond Agency Conceptions of the Work of the Non-Executive Director’ (2005) 16 *British Journal of Management* 5

⁶⁵ A Hillman and T Dalzell, ‘Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives’ (2003) 28(3) *The Academy of Management Review* 383

chapter contains a firm-level study of 30 FTSE 100 firms over a five-year period from 2006-2010. It is designed to identify factors that influence a non-executive's decision to take additional appointments, particularly their remuneration, equity and any agency problems in the firm. Rewards such as equity and remuneration for non-executives can be used to identify whether these are ways self-interest may be controlled as well as providing evidence as to whether multiple appointments are perquisite consumption. The study also aims to identify, specifically, how agency problems may influence the non-executives' decision to take external appointments. This evidence will provide support for whether additional appointments are perquisite consumption and if there is need for greater regulation of multiple directorships. Secondly, the study will also consider the relationship between governance mechanisms concerning executives such as their remuneration and non-executive external appointments. For example, since the role of the non-executive is to monitor the executive management, increases in fixed remuneration compared to long-term incentives will provide more support on whether additional appointments are perquisite consumption. This is because, as theorised by Fama,⁶⁶ and supported by Bebchuk and Fried,⁶⁷ executives should primarily be rewarded *ex post* as opposed to *ex ante* as otherwise there would be no or little incentive not to consume more perquisites after being paid *ex ante*. This analysis of executive factors will consider the relevance of behaviour and outcome based contracting.⁶⁸ Outcome and behaviour based contracting is based on the information systems between non-executives and executives. Where they are weak outcome based contracting should be preferred and likewise where information systems are strong behaviour based contracting should be preferred. Therefore the analysis will not simply

⁶⁶ E Fama, 'Agency Problems and the Theory of the Firm' (1980) 88(2) *Journal of Political Economy* 288, 306

⁶⁷ L Bebchuk and J Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, (Harvard University Press, 2006)

⁶⁸ K Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14(1) *Academy of Management Review* 57, 70

contend that higher fixed compensation to long-term incentives is a sign of poor monitoring where there are more appointments. It will account for differences in outcome and behaviour based contracting and will consider that information systems will be stronger in firms with fewer multiple appointments and vice versa. Since this analysis is multi-level over five years the data will also be tested for any changes in behaviour after the economic recession. The aim here is to consider whether changes in the economic environment will alter the conclusion from the overall analysis as to whether additional appointments are a form of perquisite consumption and what ways they may be controlled.

Whilst Chapter VI will consider the governance mechanisms that may control perquisite consumption of additional it appointments it is possible that these are not sufficient. Before considering the empirical analysis of additional appointments, this chapter will provide a comparative analysis of controls on multiple appointments in the European Union to see if there are other possible ways of controlling self-serving non-executive directors. If governance mechanisms are not suitable, other means of controlling self-interest amongst non-executives will need to be considered.

Chapter VII shall then conclude and summarise on whether fiduciary jurisdiction of conflicts of interest and corporate governance mechanisms are suitable in regulating non-executive self-interest.

Chapter II

A non-executive's fiduciary duty: When does the duty arise?

To be “accountable” for one’s activities is to explicate the reasons for them and to supply the normative grounds whereby they may be “justified”.⁶⁹

THEY USED to be a nice little sideline. Non-executive directorships - part-time and well paid - were much sought after... The ... Higgs Review on corporate governance argues that it is desirable for companies to attract good-quality independent non-executive directors. But the law needs to be clear about what is expected of them.⁷⁰

I. FIDUCIARY LIABILITY

Ensuring a non-executive director acts for the benefit and interests of the principal may be achieved by limiting the discretion of the non-executive. However, such an approach is unsatisfactory. They are usually appointed because of their expertise and limiting their discretion may mean they cannot act where it is beneficial for the principal.⁷¹ In a director-company relationship it may not be immediately apparent how to maximise the wealth of the company but this is the desired outcome.⁷² Contracting how this is to be achieved and limiting the discretion would create high contractual costs that are undesirable.⁷³ Instead, where one agrees to act for another, equity imposes proscriptions⁷⁴ that ban certain types of behaviour, which allows the principal to assess the work of the agent *ex post*. These

⁶⁹ A Giddens, *The Constitution of Society: Outline of the Theory of Structuration* (Polity, 1984) 30

⁷⁰ ---- ‘Directors chilled by fear of financial liability’ *The Times* (London 23rd September 2003) <<http://business.timesonline.co.uk/tol/business/law/article1161176.ece>> accessed 24th August 2011

⁷¹ See, R Sitkoff, ‘The Economic Structure of Fiduciary Law’ (2011) 91 B.U. L. Rev. 1039, 1040-1

⁷² See, Companies Act 2006, s. 172

⁷³ See, F Easterbrook and D Fischel, ‘Contract and Fiduciary Duty’ (1993) 36(1 part 2) *Journal of Law and Economics* 425

⁷⁴ See, for example, D Jensen, ‘Prescription and Proscription in Fiduciary Obligations’ (2010) 21 KLJ 333

proscriptions are commonly recognised as the no-profit and no-conflict rules⁷⁵ that can be collectively referred to as the fiduciary duty of loyalty.⁷⁶ The duty proscribes that the agent, in the exercise of their discretion, should be free from any self-interest. The imposition of loyalty on a non-executive then may be a suitable means of ensuring they act for the benefit of the company, as it would ban them from acting against the interests of the company.

A relationship based on trust and confidence where one agrees to act for another's benefit in respect of that other person's interests is generally considered to be a fiduciary relationship. Lord Browne-Wilkinson noted that relationship arises because the individual has 'assumed responsibility for the property or affairs of others'.⁷⁷ Millet LJ⁷⁸ elaborated on this that 'a fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence'.⁷⁹ A fiduciary relationship requires the fiduciary to be loyal to the principal. This duty of loyalty is said to be peculiar to the fiduciary relationship,⁸⁰ the "irreducible core" of such a relationship⁸¹ and it is because the individual is subject to this duty that they are a fiduciary.⁸² Therefore the duty is owed not because of the status or title of an individual but because the

⁷⁵ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 18; for discussion on whether they are two separate rules see D Kershaw, 'Lost in Translation: Corporate opportunities in comparative perspective' (2005) OJLS 603; M Conaglen, 'The nature and function of fiduciary loyalty' (2005) LQR 452

⁷⁶ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 16

⁷⁷ *Henderson and Others v Merrett Syndicates Ltd and Others* [1995] 2 A.C. 145, 205

⁷⁸ Millet LJ is now Lord Millet

⁷⁹ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 18

⁸⁰ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 16

⁸¹ *Armitage v Nurse* [1998] Ch. 241, 253-4

⁸² *Bristol and West Building Society v Mothew* [1998] Ch. 1, 18; citing P Finn, *Fiduciary Obligations* (Law Book Company, 1977) 2; also cited by *Sinclair Investment Holdings SA v Versailles Trade Finance Ltd* [2005] EWCA Civ 722; [2006] 1 B.C.L.C. 60 at [13]; *Khodari v Tamimi* [2008] EWHC 3065 (QB); [2008] C.T.L.C. 269 at [53]; *Ratiu v Conway* [2005] EWCA Civ 1302; [2006] 1 All E.R. 571 at [57]

circumstances show that the duty itself is owed. Whilst some relationships will naturally be described as fiduciary, such as director-company,⁸³ partnerships, agent-principal and trustee-beneficiary,⁸⁴ because the nature of those relationships gives rise to the duty, other relationships may also be classified as being fiduciary. Other relationships that have been classified as fiduciary on the particular facts include, *inter alia*, solicitor-client,⁸⁵ employee-employer,⁸⁶ joint ventures⁸⁷ and even parent-child in one jurisdiction.⁸⁸ These relationships, traditionally, are not fiduciary, yet on the specific facts the court was satisfied that loyalty was owed because of the relationship between the parties and not the status.

The requirement that a fiduciary is loyal to their principal means that they should not let their own or third party interests⁸⁹ conflict with those interests of the principal.⁹⁰ Since a director owes this duty then fiduciary loyalty would be a way of aligning non-executive interests with those of the company because they would be deterred from any self-interest.⁹¹ However, it

⁸³ See, for example, Companies Act 2006, s. 170; *Gas Lighting Improvement Co Ltd v Commissioners of Inland Revenue* [1923] A.C. 723; *Great Eastern Railway v Turner* [1872] L.R. 8 Ch. 149; *Perceval v Wright* [1902] 2 Ch. 421; *Automatic Self-Cleansing Filter Syndicate v Cuninghame* [1906] 2 Ch. 34 (CA)

⁸⁴ See, A Oakley, *The Modern Law of Trusts* (9th edn Thomson/Sweet & Maxwell, 2008) 404; A Hudson, *Law of Finance*, (1st edn Sweet & Maxwell, London 2009) 358

⁸⁵ *Brown v Inland Revenue Commissioners* [1965] A.C. 244

⁸⁶ *IG Index plc v Colley & Ors* [2013] EWHC 478 (QB); *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769; *University of Nottingham v Fishel* [2000] I.C.R. 1462; *Sybron Corporation v Rochem* [1984] Ch. 112

⁸⁷ *Lac Minerals Ltd v International Corona Resources Ltd* [1990] F.S.R. 441

⁸⁸ *M (K) v M (H)* (1993) 96 D.L.R. (4th) 449 (Supreme Court of Canada)

⁸⁹ Hereinafter the problem of acting for personal or third party benefit when acting for the benefit of a principal will be referred collectively as self-interest or self-regard unless otherwise stated

⁹⁰ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 18

⁹¹ See, for example, F Easterbrook and D Fischel, 'Corporate Control Transactions' (1982) 91(4) *Yale Law Journal* 698, 702

has not been particularly clear as to whether non-executives are prevented from competing with the company and thus whether the duty can deter self-interest in multiple appointments. This point was made through *dicta* in the case of *Cambridge v Makin* where the court considered it was not clear what was meant by “conflict” and thus whether non-executives could compete with the company was uncertain based on the nature of their role within the company.⁹² The concern here is the comment that non-executives may not be prevented from competing with the company as a fiduciary. This would mean they could have unfettered discretion in multiple roles with no requirement to be loyal to any one principal in particular. If that is the state of the law fiduciary duties are unsuitable for deterring non-executives from preferring their own interests in multiple roles and therefore it needs to be considered. This chapter seeks to establish whether a non-executive is prevented from competing with the company by analysing the general nature of fiduciary liability as to its purpose and in what circumstances it is owed including what types of interests are protected by fiduciary jurisdiction to see if it covers situations of acting for competing principals. This will allow for discussion in Chapter III as to what extent in a fiduciary relationship one is expected to be loyal when it is determined that the duty is owed.

Initially it may seem like a moot point as to when non-executives owe the duty. This is because directors are often described as “general fiduciaries”⁹³ in that undertaking the role and function would give rise to the duty. Also the codification of directors’ duties under the Companies Act 2006, Part 10 where Section 175 requires directors to avoid conflict of interests, which is a manifestation of the duty of loyalty sometimes referred to as the “no-

⁹² N Sinclair, D Vogel, R Snowden, *Company Directors: Law and Liability Vol 1* (Sweet & Maxwell, 1997) para 3.56-7, 3.86; cited by *Cambridge v Makin* [2011] EWHC 12 (QB) at [46]-[49]

⁹³ See, for example, *Boardman v Phipps* [1967] 2 A.C. 46, 65; cited by *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [69]

conflict” rule.⁹⁴ This section does not and nor does the Act distinguish between executive and non-executive, which are terms of business and not law. Thus one may expect the duty to be equally applicable to both executives and non-executives. However, section 170(4) states that the duties will continue to be interpreted and applied in the same way as the common law and equitable rules. Under common law and equitable rules interpretation of fiduciary duties has often recognised that an individual will owe the duty based on the nature and extent of the relationship they have with another individual’s property, rather than status or title.⁹⁵ If the nature of the relationship is different, such as the case will be for non-executives and executives, they will not necessarily owe the duty in the same circumstances so it needs to be considered in what circumstances the duty is owed. Millet LJ made the point that not every breach by a fiduciary will be a fiduciary breach⁹⁶ and Lord Browne-Wilkinson argued that fiduciaries would not owe the duty in the same circumstances⁹⁷ and that when determining liability for fiduciaries, to reason by analogy is dangerous.⁹⁸ Thus it is not unreasonable to consider when non-executives incur fiduciary accountability as their role and function may be different from an executive’s role. Although the facts concerned events that happened pre-codification, the decision in *Cambridge* serves to highlight the distinct possibility, and even willingness from the court, to distinguish when fiduciary duties are owed by non-executives based on the role they assume within the company. Despite developments in the common law uncertainty clearly persists in understanding duties owed by non-executives. ‘I know that the law on non-executive directors is potentially unclear and

⁹⁴ See, R Flannigan, ‘The Boundaries of Fiduciary Accountability’ (2004) *New Zealand Law Review* 215, 223-4

⁹⁵ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 18; J Edelman, ‘When do fiduciary duties arise?’ (2010) 126 LQR 302

⁹⁶ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 16; see also, *Lac Minerals Ltd v International Corona Resources Ltd* [1990] F.S.R. 441

⁹⁷ *Henderson and Others v Merrett Syndicates Ltd and Others* [1995] 2 A.C. 145, 205

⁹⁸ *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769 at [24]

is certainly not tested to any great extent in the courts.⁹⁹ 'A central concern with any form of legal accountability is the reach of its application. It is critical to properly identify who is subject to the regulation.'¹⁰⁰

II. THE PURPOSE OF LOYALTY

a. The traditional orthodox approach

Where one agrees to act for another's interests trust and confidence is placed in the fiduciary that they will use their discretion for the benefit of the principal. However, the principal may have little ability to control and monitor what the fiduciary is doing once they have undertaken responsibility to act for them. A company is an artificial entity that cannot monitor its directors; beneficiaries may not be able to monitor the trustee especially if the beneficiary is an infant. Therefore the principal is in a vulnerable position to the fiduciary.¹⁰¹ The fiduciary is in the stronger position whilst acting for the other's benefit and so there is a concern that when acting for that person they may not do so properly.

The concern is that the fiduciary will use their undertaking to act opportunistically for their own benefit and not for the principal's benefit. With the fiduciary in a stronger position to his or her principal where informational asymmetries exist they may be able to manipulate information and the principal will find it difficult to effectively monitor whether there was a conflict. Even those who do not intentionally prefer their own interests may do so. Kershaw notes that 'behavioural psychology teaches us that conflicted parties, even those who believe that they act honestly and in good faith, cannot trust themselves to give impartial

⁹⁹ Hansard HL Vol 678, Official Report 6/2/06 Col GC288

¹⁰⁰ R Flannigan, 'Access or Expectation: The test for fiduciary accountability' (2010) 89(1) *The Canadian Bar Review* 1

¹⁰¹ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 18; *Lac Minerals Ltd v International Corona Resources Ltd* [1990] F.S.R. 441, 444

advice'.¹⁰² As Flannigan explains that the purpose for imposing loyalty on a fiduciary is because there is a need 'to strictly control the self-regarding instincts'.¹⁰³ Therefore the duty loyalty is imposed to minimise the human agency concern of self-regard where one agrees to act for another.¹⁰⁴

It has long been recognised by the courts that the concern of fiduciary jurisdiction is self-interest in the performance of one's functions in such relationships. If the fiduciary were allowed to act with self-regard 'it is very obvious what would be the consequences of letting trustees have the lease on refusal to renew to the *cestui que use*'.¹⁰⁵ 'The trustee's situation in respect of the estate, gives him access to the landlord; and it would be dangerous to permit him to make use of that access for his own benefit.'¹⁰⁶ Millet LJ has also noted that 'mere incompetence is not enough. A servant who loyally does his incompetent best for his master is not unfaithful and is not guilty of a breach of fiduciary duty.'¹⁰⁷ Millet LJ recognises that not every breach by a fiduciary is a fiduciary breach; it is only those breaches influenced by, or where there was a risk of, self-regard.¹⁰⁸ Conaglen submits that:

This understanding of the function served by fiduciary doctrine is present and consistent throughout the case law. In *Whichcote v Lawrence*, for example, Lord Loughborough LC explained that the concern when a trustee buys trust property for himself is that he 'is not

¹⁰² D Kershaw, 'Does it matter how the law thinks about corporate opportunities?' (2005) 25(4) LS 533, 554

¹⁰³ R Flannigan, 'Access or Expectation: The test for fiduciary accountability' (2010) 89(1) *The Canadian Bar Review* 1

¹⁰⁴ *Item Software (UK) Ltd v Fassihi* [2004] EWCA Civ 1244; [2004] B.C.C. 994 at [66]; see also, S Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' (2002) 97(2) *Nw U. L. Rev.* 547

¹⁰⁵ *Keech v Sandford* (1726) 25 E.R. 223, 224

¹⁰⁶ *Blewett v Millett* (1774) 7 Bro. 367, 373

¹⁰⁷ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 18; see also, *Hodgkinson v Simms* [1994] 3 S.C.R. 377, 405

¹⁰⁸ see also, R Flannigan, 'Fiduciary duties of shareholders and directors' (2004) *Journal of Business Law* 277

acting with that want of interest, that total absence of temptation' because 'where a trustee has a prospect of advantage to himself, it is a great temptation to be negligent'.¹⁰⁹

The purpose of the duty is to remove the temptation of self-interest because where there is the possibility of personal gain in the performance or function of their undertaking to the principal they may be negligent in that performance or function. "Negligent" is not used in the strict legal sense of the word but it is considered that it is used in the sense that where the individual has a function to perform for the benefit of another but stands to benefit personally there is a risk they may not perform their function properly. This may include negligence if that negligence is influenced by self-regard, as Millet LJ noted, but it may also include other situations such as opportunistic behaviour through omissions, for example so as to advance one's own self-interest when acting for another.

The duty therefore has a prophylactic function in guarding against the improper, negligent or otherwise, performance of a fiduciary's obligations where self-interest is involved. To ensure that temptation is removed the standard of liability for breach of fiduciary duty is strict and famously stated by Lord Cranworth LC that: 'It is a rule of universal application that no one having such duties to discharge shall be allowed to enter into engagements in which he has or can have a personal interest conflicting or which possibly may conflict with the interests of those whom he is bound to protect.'¹¹⁰ This strict standard of liability is now codified in section 175(1) of the Companies Act 2006 which states, 'a director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company'. Strict liability is seen in the wording that a director "must avoid" conflicting situations.

¹⁰⁹ M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010) 63; citing *Whichcote v Lawrence* (1798) 3 Ves 740, 750, 752 (30 ER 1248)

¹¹⁰ *Aberdeen Rail v Blaikie Brothers* [1843-60] All E.R. Rep. 249, 252

Conaglen observes the duty is not concerned with proving an actual conflict but the duty 'focuses its attention on circumstances where there is a *risk* that the duty might be breached.'¹¹¹ This is seen in *Keech v Sandford*: 'This may seem hard, that the trustee is the only person of all mankind who might not have the lease; but it is very proper that the rule should be strictly pursued, and not in the least relaxed.'¹¹² Protecting against the risk of a conflict, and not necessarily an actual one, incorporates the prophylactic concerns of the duty. The court only enquires as to whether there was a risk that the fiduciary preferred their, or third party, interests to the principal's interests. It is not concerned with whether the fiduciary acted in good faith, tried his or her hardest to obtain the opportunity, or whether the principal could have the opportunity. With *Keech*, for example, whilst the beneficiary could not take the lease, objectively they were interested in it. Therefore the trustee could not take it personally. If they were allowed to take it personally there is the risk that the self-interest would create the temptation to not perform the function of pursuing the lease for the beneficiary properly. The purpose is fulfilled through strict liability as it removes any temptation for the fiduciary to not perform their functions properly.

Cases that show the court's disregard for factors that try to excuse a conflict are legion. Beyond *Keech*, cases often cited to demonstrate the standard are *Regal (Hastings) v Gulliver*,¹¹³ *Boardman v Phipps* and *Bhullar v Bhullar*.¹¹⁴ In *Regal*, which is considered the leading case for company directors, the company, according to the directors, did not have the finances to purchase a cinema. The directors then invested in the company personally so the company could purchase. On the eventual sale of the company as a going concern they were liable for the profit they made on those shares. Similar in *Boardman*, the

¹¹¹ M Conaglen, 'The nature and function of fiduciary loyalty' (2005) 126 LQR 452, 461

¹¹² *Keech v Sandford* (1726) 25 E.R. 223, 224

¹¹³ *Regal (Hastings) Ltd v Gulliver and Others* [1967] 2 A.C. 134

¹¹⁴ *Bhullar v Bhullar* [2003] EWCA Civ 424; [2003] B.C.C. 711

beneficiaries declined to take extra shares in a company that the fiduciaries to the trust said was underperforming. When the fiduciaries purchased personally they became in conflict and liable to disgorge their profit. This was despite also making a profit for the trust. Finally, in *Bhullar* although the company was in deadlock and unwilling to take on any new opportunities, when the directors purchased an adjacent property, which they discovered outside the discharge of their functions, they were still held liable for a conflict of interest. Jonathan Parker LJ held that 'whether the company could or would have taken the opportunity, had it been made aware of it, is not to the point'.¹¹⁵

Whilst liability is strict it is not absolute and directors may absolve themselves from liability by obtaining authorisation. For directors this can be done following the procedure set out in section 175(4)(b). For the authorisation to be valid that disclosure must be in full¹¹⁶ with clear evidence to support it.¹¹⁷ It is often argued that the failure to disclose is a telling fact in itself.¹¹⁸ For if the fiduciary honestly believes there was no conflict then they should have sought authorisation.

b. Alternative approach to liability

The standard does show that liability can only be avoided if authorisation is given yet attempts are often made to justify other defences. One of the most cited examples is the Canadian authority in *Peso Silver Mines v Cropper*.¹¹⁹ Here the director avoided liability where he pursued an opportunity that the company had rejected on a fully informed, bona fide basis. After this it was presented to the director by a third party with no new information.

¹¹⁵ *Bhullar v Bhullar* [2003] EWCA Civ 424; [2003] B.C.C. 711 at [41]

¹¹⁶ *Boardman v Phipps* [1967] 2 A.C. 46, 109

¹¹⁷ *York and North Midland Railway Co v Hudson* (1845) 16 Beav. 485, 491

¹¹⁸ See, for example, R Flannigan, 'The Boundaries of Fiduciary Accountability' (2004) *New Zealand Law Review* 215, 223

¹¹⁹ *Peso Silver Mines v Cropper* [1966] S.C.R. 673

If such facts would appear before an English court a conflict would be present because liability is strict and it would not matter that the company could or would not take the opportunity, making the case incompatible with the English orthodox approach. Those who propose *Peso* is adaptable to the English approach often fail to provide a reasonably convincing argument as to why the director did not seek authorisation if he honestly believed the company to not be interested in the opportunity. Lim's article on this matter fails to do exactly this, which means his argument that the prophylactic concerns of the duty are removed – because of the facts mentioned above – as a means of justifying *Peso* to be compatible with the English approach is flawed.¹²⁰ Did he not seek authorisation because he feared the company would change its mind and pursue what he viewed to be a commercially viable opportunity? If he believed it to be commercially viable why did he not try to convince the company to take it again? These are not questions the court will consider but they demonstrate clearly that the prophylactic concerns remain. What remains with *Peso* from an English perspective is that the director failed to treat his interests as subservient to his duty without authorisation and so there was a risk he would not perform his functions properly. Furthermore, Lim's submission that the omission of the word "would"¹²¹ from the Companies Act 2006, s. 175(2) where it states 'This [the duty] applies in particular to the exploitation of any property, information or opportunity (and it is immaterial whether the company *could* take advantage of the property, information or opportunity)' (emphasis added) means that upon a literal interpretation a company that is unwilling (would) to pursue an opportunity, rather than incapable (could), would mean a director can pursue it personally is unlikely. This is because first and foremost the duties in Part 10 of the Companies Act 2006 are a general statement. The general statement was adopted, *inter alia*, to allow the courts to develop duties that are not "well-settled".¹²² It is not a precise definition of when the duty will be

¹²⁰ E Lim, 'Directors' fiduciary duties – A new analytical framework' (2013) 129 LQR 242, 247-8

¹²¹ E Lim, 'Directors' fiduciary duties – A new analytical framework' (2013) 129 LQR 242, 246

¹²² See, for example, Law Commission Report (No 261 1999) paras 4.7, 4.11-13

breached. The omission of the word “would” then does not mean such circumstances of unwillingness, where the company would not pursue the opportunity, are precluded. This can be supported by Lord Goldsmith’s approval of Lord Upjohn’s judgment in *Boardman* that ‘rules of equity have to be applied to such a great diversity of circumstances that they can be stated only in the most general terms and applied with particular attention to the exact circumstances of each case’.¹²³ Therefore cases such as *Regal* and *Bhullar*, that are examples of when a company has been unwilling rather than incapable of pursuing an opportunity, are still to be followed and a director cannot defend a claim by arguing unwillingness on the part of the company as it is the director’s duty to pursue what the company is interested in.

Loyalty, therefore, in a fiduciary relationship is generic:

Fiduciary accountability is generic in the sense that the same proscriptions apply, for the most part, to all fiduciary relations. The fiduciary rules that constrain agents are essentially the same rules that constrain trustees, partners, solicitors, and other fiduciaries. It is therefore somewhat inaccurate to assert that fiduciary responsibility varies according to the nature of the relations involved. Yet that is a popular assertion. Fiduciary responsibility is largely constant because it has been constructed in response to a generic mischief ... The proper view is that all limited access arrangements are regulated by the full expanse of fiduciary accountability.¹²⁴

It seeks to remove the temptation of not performing one’s functions properly where there is the prospect of personal gain by imposing strict liability regardless of whether the fiduciary is a non-executive, employee, agent or any other fiduciary. If that regulation was not strict the purpose could not be fulfilled as the fiduciary, in the stronger position, may be able to manipulate information to act for their own benefit. The purpose and standard of liability shows a non-executive must demonstrate single-minded loyalty and treat all other interests

¹²³ Hansard HL Vol 681, Official Report, 9/5/06 Col 863; citing *Boardman v Phipps* [1967] 2 A.C. 46, 123

¹²⁴ R Flannigan, ‘The Boundaries of Fiduciary Accountability’ (2004) *New Zealand Law Review* 215, 222

as subservient so as to remove the risk that they do not perform their functions for the one they are bound to protect.

c. Types of interest

In *Cambridge* it was considered it was not clear what was meant by a conflict and whether non-executives would be prevented from competing with the company. The court seemed unsure as to the position regarding duty-duty conflicts, meaning there is a conflict between two duties owed to different principals. What interests are covered by fiduciary loyalty needs to be considered to see if such competing interests would be covered by fiduciary jurisdiction.

For a conflict there must of course be an interest of the company and interest of the director. For the latter, Conaglen establishes that the courts have taken a wide meaning to what is meant by “interest” and that it does not have to be beneficial.¹²⁵ Thus the interest pursued in conflict of the principal’s interest does not have to be a personal one. This should be clear because the duty requires the fiduciary to treat any interests that conflict with their principal’s as subordinate and owe single-minded loyalty to the principal. These points, of single-minded loyalty and the interest not needing to be beneficial, can be seen in section 175(7) that confirms the duty to avoid a conflict of interest includes a duty-duty conflict. This was the case in *Extrasure Travel Insurances Ltd v Scattergood*.¹²⁶ The directors used property obtained in one capacity to aid the survival of another firm in the group. In such a situation, whilst the director may not have personally gained from such a conflict, by using the property of interest to one principal to benefit another they had not shown single-minded loyalty to the first principal by subordinating the interests of the other. Millet LJ emphasised that acting for competing principals would be covered. He said ‘a fiduciary who acts for two principals with

¹²⁵ M Conaglen, ‘Fiduciary regulation of conflicts between duties’ (2009) 125 LQR 111, 115

¹²⁶ *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 B.C.L.C. 598

potentially conflicting interests without the informed consent of both is in breach of the obligation of undivided loyalty; he puts himself in a position where his duty to one principal may conflict with his duty to the other'.¹²⁷

As well as the interest not having to be beneficial, neither does it have to be successfully pursued for there to be an interest.¹²⁸ However, in such situations where no personal benefit is gained such as property or a profit the favourable remedy of it being held on constructive trust is not available since it requires some identifiable property in possession of the fiduciary.¹²⁹ In the absence of a constructive trust it may be possible to seek a remedy for equitable compensation although this would mean they rank below any other creditors, as they no longer have a proprietary claim. A remedy of equitable compensation is also harder to prove beyond establishing strict liability because the company would need to demonstrate a casual link between the director acting in conflict and harm to the company for a successful claim.¹³⁰

What may constitute an interest of the principal could be infinite, but for companies section 175(2) of the 2006 Act stipulates that a conflict of interest in particular applies to property, information or opportunity. Although not a prerequisite: where the company owns the property or information the issue has been uncontroversial. Property can be viewed as having ownership rights against all third parties. Information is less clear but trade secrets, inside information or client lists for example, are often described as property,¹³¹ even if it is

¹²⁷ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 19; see also, *Clark Boyce v Mouat* [1993] 1 A.C. 428, 435-6

¹²⁸ See, for example, *Item Software (UK) Ltd v Fassihi* [2004] EWCA Civ 1244; [2004] B.C.C. 994

¹²⁹ *Re Barney* [1892] 2 Ch. 265

¹³⁰ *Item Software (UK) Ltd v Fassihi* [2004] EWCA Civ 1244; [2004] B.C.C. 994 at [66]; see also, M Conaglen, 'Equitable compensation for breach of fiduciary dealing rules' (2003) 119 LQR 246

¹³¹ See, for example, *Berryland Books Ltd v BK Boots Ltd* [2009] EWHC 1877; [2009] 2 B.C.L.C. 709 (ch) at [22]

technically not property in the strict sense of the word.¹³² Both are also capable of being reified. It is even unnecessary to revert to fiduciary law principles when the company actually owns the property or information. The use of confidential information may be a breach of confidence.¹³³ Information as to an opportunity may also be brought within the scope of breach of confidence as the boundaries are seen as interchangeable.¹³⁴ Where a fiduciary uses the property of the trust, or a director uses company property, a claim in conversion¹³⁵ may be brought with the potential for a proprietary claim.¹³⁶ Equally, in the example of *Extrasure* above, the company may have brought a claim for knowing receipt of corporate property,¹³⁷ or even complicity in the breach of duty, against the third party.¹³⁸ A claim against a third party may be harder to prove than strict liability¹³⁹ but preferable, as a personal claim against a director could be undesirable as they may have parted with any profit or be uninsured,¹⁴⁰ along with a low order in creditor preference.

¹³² *Boardman v Phipps* [1967] 2 A.C. 46, 127

¹³³ *Boardman v Phipps* [1967] 2 A.C. 46, 127-8; see also T Wu, 'Confidence and the Constructive Trust' (2003) 23 LS 135

¹³⁴ *Douglas v Hello! Ltd* [2001] Q.B. 967, 1011

¹³⁵ There is strict liability for a claim in conversion similar to that under fiduciary law, see, for example, *Kuwait Airways Corp v Iraqi Airways Co (no 6)* [2002] UKHL 19; [2002] 2 A.C. 883

¹³⁶ See, for example, A Oakley, *The Modern Law of Trusts* (9th edn Thomson/Sweet & Maxwell, 2008) 404-6, 424; A Hudson, *Law of Finance*, (1st edn Sweet & Maxwell, London 2009) ch 24 and 717-8

¹³⁷ *El Ajou v Dollar Land Holdings Plc* [1994] 2 All E.R. 685; *Bank of Credit and Commerce International (Overseas) Ltd v Akindele* [2001] Ch. 437; cf. Companies Act 2006, s. 40; R Stevens, 'The Proper Scope of Knowing Receipt: Criterion Properties v Stratford UK Properties' (2004) *Lloyd's Maritime and Commercial Law Quarterly* 421

¹³⁸ *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 A.C. 378, PC; *Twinsectra Ltd v Yardley* [2002] 2 A.C. 164, HL

¹³⁹ See, for example, *El Ajou v Dollar Land Holdings Plc* [1994] 2 All E.R. 685, per Hoffman LJ on criteria for knowing receipt; A Oakley, *The Modern Law of Trusts* (9th edn Thomson/Sweet & Maxwell, 2008) 424-40

¹⁴⁰ *Selangor United Rubber Estates v Cradock (No. 3)* [1968] 1 W.L.R. 1555

Opportunities, however, are potentially open ended. The difficulty for the court and academics alike is when a director can pursue opportunities personally. They are not tangible like property, or relevant to a certain type of process such as trade secrets. Thus a company cannot own an opportunity.¹⁴¹ Yet acting for another will undoubtedly give an individual access to potential opportunities that they would otherwise not have had. Likewise, directors may also hear of opportunities outside the performance of their duty that are possibly of interest to the company. Therefore the courts and the legislator have recognised the potential for conflicts of interest in regard to opportunities.

Corporate opportunities may be relevant to a number of situations. They may include opportunities relating to property, information or business opportunities. For example, in *Boardman* the opportunity was in regard to information relating to a company, whereas in *Bhullar* the opportunity was relevant to property. Alternatively, in *Balston Ltd v Headline Filters Ltd*¹⁴² the opportunity was a business opportunity in relation to the supply of filter tubes. Hereinafter different types will simply be referred to as either an opportunity or corporate opportunity.

It is worth distinguishing here between information about an opportunity and general information received by a fiduciary. The Court of Appeal held that a director is allowed to use their 'stock-in-trade'.¹⁴³ Therefore, general information such as the business contacts, knowledge of the market or the value of property can be used by the fiduciary personally because it is not of specific interest to the principal. To use some examples: The information as to the shares in *Boardman* was of specific relevance to the trust because the trust had

¹⁴¹ *Boardman v Phipps* [1967] 2 A.C. 46, per Lord Upjohn

¹⁴² *Balston Ltd v Headline Filters Ltd* [1990] F.S.R. 385

¹⁴³ *Foster Bryant Surveying Ltd v Bryant* [2007] EWCA Civ 200; [2007] B.C.C. 804 at [8]; *Thermascan Ltd v Norman* [2009] EWHC 3694 (Ch); [2011] B.C.C. 535 at [14]-[15]

existing ownership in the company, as well as the information being obtained in their capacity as fiduciaries. Even if the information had been obtained outside their capacity as trustees they would have still been liable.¹⁴⁴ By purchasing the shares personally there was a risk of conflict because they had not treated their interest as subservient to the principal's interest. As well in *Bhullar*, the opportunity was of specific relevance to the principal who had pre-existing dealings in investment properties. The locality of the property also made it of specific interest as it was adjacent to the company's existing property and being used for car-parking by the company. If the case had simply been a matter of car-parking space adding value to a company and the individual purchased an unrelated car parking lot of no interest to the company then they would probably have had no specific interest and the fiduciary would be free to use this information personally because it is only of general interest to the principal. Therefore a non-executive would not be prevented from using their general "stock-in-trade" for another principal, what matters is if their specific interests compete.

Notably, acting for two principals regardless of what the interest is, whether it is property, information or opportunities, will be covered since the fiduciary is meant to show undivided loyalty and treat all other interests as subservient. It seems that a non-executive serving for multiple principals would not be able to compete with the interests of the principal without authorisation as the purpose of fiduciary jurisdiction is to remove the temptation to not perform one's functions properly where self-interest is involved by imposing strict liability. Any attempt by the non-executive to act other than for the interests of the principal will be prevented unless authorisation is given and so duty-duty conflicts and any competition would be covered by the jurisdiction.

¹⁴⁴ S Beck, 'The Saga of Peso Silver Mines: Corporate Opportunity Reconsidered' (1971) 49(1) *Canadian Bar Review* 80, 89; cited Lindley, *Law on Partnership*, vol 1 (4th edn 1878) 572; *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [54]

d. Liability in duty-duty conflicts

Whilst it is considered that liability is strict and a non-executive could not compete with another principal against his or her own principal, as other interests must be subservient, another contention is that liability is different where there is duty-duty conflict. Case law on the consequences of multiple appointments is seldom. This was observed in *Cambridge*: The complaint in *Cambridge* was that two directors of NRSPI had an interest in CINTRA Ltd, as a director and employee, which obtained the former's data. It was alleged this data was used by CINTRA Ltd to obtain contracts to a point where NRSPI could not compete.¹⁴⁵ Tugendhat J observed 'there is little assistance in the case law or commentaries on what has and has not been held to be amount to a conflict of interest in circumstances which are comparable to those in the present case'.¹⁴⁶

From above it is made clear that liability is strict to fulfil the purpose of the duty. From the orthodox approach any attempt by a fiduciary to subordinate his principal's interests to another principal's interests will breach his duty unless he or she has received prior authorisation based on full disclosure. Yet certain decisions and academic opinion have been given that may suggest fiduciary liability for duty-duty conflicts should be approached differently. These approaches need to be considered to see if the purpose of imposing strict liability to avoid the risk of disloyalty is not followed in duty-duty conflicts and would allow a non-executive to compete against the company.

¹⁴⁵ *Cambridge v Makin* [2011] EWHC 12 (QB) at [6]

¹⁴⁶ *Cambridge v Makin* [2011] EWHC 12 (QB) at [46]

i. Information received qua director or owned by the company

The first significant instance of a different approach was in *Bell v Lever Brothers*.¹⁴⁷ *Lever Bros* cited *London and Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd*¹⁴⁸ with approval where no conflict of interest was found based on the fact the director had no involvement in one of the two competing companies the individual was a director of. In *Lever Bros* the director was more involved with the principals concerned. Lord Blanesburgh's *dictum* was that the directors were not precluded, if not for the express agreement between the parties, from entering in to "private speculations",¹⁴⁹ despite the fact their private speculations were in cocoa, which the company was known to trade in. He considered that an individual is:

At liberty to become a director even of a rival company, and it not being established that he was making to the second company any disclosure of information obtained confidentially by him as a director of the first company he could not at the instance of that company be restrained in his rival directorate. What he could do for a rival company, he could, of course, do for himself.¹⁵⁰

With this in mind he also noted that:

Liability of a director in respect of profits made by him from a contract in which his company also is concerned is one thing: his liability, if any there be, in respect of his profits from a contract in which the company has no interest at all is quite another ... In the second case, the company has no concern in his profit and cannot make him accountable for it unless it appears - this is the essential qualification - that in earning that profit he has made use either of the property of the company or of some confidential information which has come to him as a director of the company.¹⁵¹

¹⁴⁷ *Bell v Lever Brothers* [1932] A.C. 161

¹⁴⁸ *London and Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd* [1891] W. N. 165

¹⁴⁹ *Bell v Lever Brothers* [1932] A.C. 161, 194-196

¹⁵⁰ *Bell v Lever Brothers* [1932] A.C. 161, 195

¹⁵¹ *Bell v Lever Brothers* [1932] A.C. 161, 194

Lord Blanesburgh considered that a director could serve on competing boards, and the director could be bound in a contract to some outside party, as long as they did not make use of company property or some confidential information that had come to him as a director of the company.

The deficiency in this reasoning is clear. The duty is one of single-minded loyalty.¹⁵² It should not matter whether or not the company owned the property since the duty merely requires an interest and not ownership. If the individual is interested in an opportunity that conflicts with what the interests of the principal are, liability cannot be avoided on the basis the company did not own the information or it was received outside the function of director. If it was of interest to the principal the director could not act for the interests of another principal. Liability could only be avoided if authorisation was given. It is therefore of no surprise that the Court of Appeal, notably Brooke and Sedley LLJ, in *Plus Group Ltd v Pyke* treated the decision in *Lever Bros* with scepticism and as most likely incorrect. Sedley LJ noted, for what if a director used his boardroom vote to assist a competitor when the 'competitor was the director himself or another company of which he was also a director'.¹⁵³ Here Sedley LJ implicitly refers to the prophylactic concerns for imposing the duty, which is a director may act opportunistically where his interest to another principal conflicts with his duty to another. He considered that the notion that if the current state of the law is that there would be no breach of fiduciary duty by being involved in a similar or competing business, then it needs to be revised.¹⁵⁴

¹⁵² See, for example, *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769 at [41]-[43]

¹⁵³ *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [80]

¹⁵⁴ *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [80]

ii. Appreciating the fiduciary acts for multiple principals

Another instance where fiduciary liability has not followed the strict orthodox approach to fiduciary liability was in *Rossetti v Diamond Sofa Company Ltd.*¹⁵⁵ The case related to an agency fiduciary relationship, but the judgment is still interesting to observe in this context. Lord Neuberger delivered the judgment that Rimer and Moses LLJ agreed with. As a general rule he found that it would be a breach of fiduciary duty to act for competing principals but identified two situations where a fiduciary may act for a competing principal: (1) the principals agree to them so acting; and (2) where the principal appreciated it was the fiduciary's business to act for multiple principals.¹⁵⁶ The first exception is well established, as prior authorisation to act will prevent the director from liability. However, the second exception is not clearly established. The defence is more akin to a defence for a section 177 breach to declare an interest in a proposed transaction, where a director may avoid liability by claiming the company knew or ought to have known of the interest,¹⁵⁷ rather than a section 175 incidence where only authorisation based on full disclosure will excuse any conflict. Section 177, or self-dealing, transactions are removed from a traditional conflict of interest, as demonstrated by section 175(3), because the company is the one dealing, either directly or indirectly, with the director. If the company chooses to deal with one of their own they cannot later hold the director liable for a conflict because they were fully, or at least reasonably ought to have been, aware with whom they were dealing.¹⁵⁸ However, with conflicts under section 175 the company has no control and cannot choose to withdraw from a transaction on the knowledge that one of their own is involved since they are merely interested in the same opportunity and not dealing with one another. The analysis of strict

¹⁵⁵ *Rossetti v Diamond Sofa Company Ltd* [2012] EWCA Civ 1021

¹⁵⁶ *Rossetti v Diamond Sofa Company Ltd* [2012] EWCA Civ 1021 at [22]-[23]

¹⁵⁷ Companies Act 2006, s. 177(6)(b)

¹⁵⁸ See, for example, *Bristol and West Building Society v Mothew* [1998] Ch. 1, 19; *Runciman v Walter Runciman plc* [1992] B.C.L.C. 1084

liability for a breach means it is unlikely a court will tolerate a conflict on the basis that the principal knew it was the fiduciary's business to act for multiple principals. In *Boardman*, for example, the beneficiaries were fully aware of the trustees' intention to purchase, and even encouraged them to do so. Yet they did not avoid liability because there was still that risk of conflict. It is commonplace for non-executives to act for multiple principals but this does not mean the company should tolerate a conflict of interest unless it was authorised. This point has been made clear, and cited with approval in relation to duty-duty conflict that:

No agent who has accepted an employment from one principal can in law accept an engagement inconsistent with his duty to the first principal from a second principal, unless he makes the fullest disclosure to each principal of his interest, and obtains the consent of each principal to the double employment.¹⁵⁹

Strict fiduciary liability cannot be reduced by the fact that the principal knew it was the fiduciary's business to act for multiple principals. Such leniency would easily allow the fiduciary to be negligent or opportunistic if they deem it preferable to prefer one principal to the other. The court would not enquire as to whether the company knew the director normally acted for multiple principals; they will simply look to see whether the situation can reasonably be regarded as likely to giving rise to a possible conflict.

iii. Acting fairly between principals

This situation is not too dissimilar from the previous contention to treat duty-duty conflicts differently. The notion moves away from the strict orthodox approach and contends liability can be avoided provided the fiduciary acts fairly between the principals after authorisation is

¹⁵⁹ *Fullwood v Hurley* [1928] 1 K.B. 498, 502; cited with approval in *Farrington v Rowe McBride & Partners* [1985] 1 N.Z.L.R. 83, 90; *Clark Boyce v Mouat* [1993] 1 A.C. 428, 436; *Bristol and West Building Society v Mothew* [1998] Ch. 1, 19

given to act for multiple principals.¹⁶⁰ Conaglen postulates that an inhibition principle¹⁶¹ exists when acting for multiple principals. He cites *Bristol and West Building Society v Mothew* that provides whilst a fiduciary with competing duties may have authorisation to do so, there is still a requirement to act in good faith and not prejudice one principal over the other. The statement continued that this duty goes further than that and the fiduciary must not allow the performance of his obligations to one principal be influenced by the other.¹⁶² The wording that the duty goes beyond good faith lead Conaglen to argue that this is a duty of inhibition which is peculiar to fiduciaries beyond a fiduciary's duty to act in good faith¹⁶³ which is not peculiar to fiduciaries.¹⁶⁴ This inhibition principle, according to Millet LJ, is that a fiduciary:

Must not allow the performance of his obligations to one principal to be influenced by his relationship with the other. He must serve each as faithfully and loyally as if he were his only principal. Conduct which is in breach of this duty need not be dishonest but it must be intentional. An unconscious omission which happens to benefit one principal at the expense of the other does not constitute a breach of fiduciary duty, though it may constitute a breach of the duty of skill and care. This is because the principle which is in play is that the fiduciary must not be inhibited by the existence of his other employment from serving the interests of his principal as faithfully and effectively as if he were the only employer. I shall call this "the no inhibition principle." Unless the fiduciary is inhibited or believes (whether rightly or

¹⁶⁰ For a detailed analysis of duty-duty conflicts in this context see, M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010) 142-176

¹⁶¹ As developed in *Bristol and West Building Society v Mothew* [1998] Ch. 1, 20

¹⁶² M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010) 150; citing *Bristol and West Building Society v Mothew* [1998] Ch. 1, 19

¹⁶³ M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010) 151

¹⁶⁴ See, for example, M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010) 40; R Flannigan, 'Fiduciary duties of shareholders and directors' (2004) *Journal of Business Law* 277

wrongly) that he is inhibited in the performance of his duties to one principal by reason of his employment by the other his failure to act is not attributable to the double employment.¹⁶⁵

However, it is difficult to see how this is any more than the duty to act in good faith, which Conaglen himself concedes is at least a possibility.¹⁶⁶ Once the conflict between duties is authorised the fiduciary must still adhere to his duty of good faith to both principals. This can be seen in the Court of Appeal in *Pyke* where Gower's textbook on company law was cited with approval:

In arguing that a director who carries on a business which competes with that of his company inevitably places himself in a position where his personal interest will conflict with his duty to the company, it is not being contended that he will necessarily have breached his fiduciary duty; he will not if the company has consented ... Nor is it being suggested that there is anything objectionable in his holding other directorships so long as all the companies have consented if their businesses compete. But in both cases consent is unlikely if he is a full-time executive director or if the extent of the competition is substantial. And even if the consent is given the director is likely to be faced with constant difficulties in avoiding breaches of his subjective duty of good faith to the company or companies concerned.¹⁶⁷

The premise here is that whilst competing companies may authorise a director to serve on both boards, that director may have difficulty in meeting their subjective duty of good faith, which would require the director to act fairly, but this is not a fiduciary duty. *Farrington v Rowe McBride & Partners* also made this point that 'there will be some circumstances in which it is impossible, notwithstanding such disclosure, for any solicitor to act fairly and adequately for both'.¹⁶⁸ As Gower makes clear, only authorisation will prevent fiduciary

¹⁶⁵ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 19

¹⁶⁶ M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010) 151

¹⁶⁷ *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [83]; citing J Gower, *Principles of Modern Company Law*, (6th edn Sweet & Maxwell, 1997) 622

¹⁶⁸ *Farrington v Rowe McBride & Partners* [1985] 1 N.Z.L.R. 83, 90

liability where the director has competing duties to multiple principals, acting fairly will not. That consent to an otherwise breach of fiduciary liability does not bring about a new fiduciary duty i.e. the inhibition principle otherwise it would make the original authorisation moot. The breach of loyalty would have been authorised and they cannot later complain the director has been disloyal when they were fully aware of the terms upon which the director was acting. However what Millet LJ and Gower both refer to is that once that consent is given to act for both principals it does not give authorisation to the director to not perform his other functions properly. The director still has the function to act in good faith and must still be observed. He cannot intentionally let his interest in one firm influence his interest in another otherwise this will evidence bad faith. The cases of *Pyke* and *Farrington* show holding double employment for competing principals may be authorised and not a breach of fiduciary duty but it may be very difficult to adhere to the duty of good faith in such circumstances.

Overall, loyalty is generic to strictly regulate self-interest.¹⁶⁹ Whether the fiduciary seeks to prefer his or her own, or a third party's, interests when acting to benefit another, loyalty will operate in the same way to remove that temptation by imposing strict liability. Therefore there does not seem to be sufficient support or justification for relaxing the duty to avoid conflicts under section 175 in duty-duty conflicts as opposed to interest-duty conflicts. If the prophylactic justifications remain in duty-duty conflicts there should be no reason to treat any disloyalty differently. The outcome is loyalty requires the fiduciary to put aside self or third party interest and treat it as subservient to the interests of the principal. Where they fail to do so the duty of loyalty seeks to regulate that disloyalty by imposing strict liability. At this point, it is clear that the ability for a non-executive to prefer the interests of other principals, or their own when acting for them, is narrow due to strict liability and being limited to the defence of full disclosure authorisation. If a non-executive wishes to pursue an interest for a principal in conflict with the interests of another, authorisation would have to be sought otherwise the

¹⁶⁹ See, R Flannigan, 'The Boundaries of Fiduciary Accountability' (2004) *New Zealand Law Review* 215, 222

temptation to prefer one principal is removed by strict liability. Therefore they cannot compete with their principal. Initially, fiduciary duties demonstrate a stringent means of *ex post* control on multiple appointments as the director is very limited in the way he can prefer one company over another if he acts for both. Having established that the purpose of the duty is to regulate self-interest and that liability is strict where other interests are not subservient to the principal's, it needs to be considered in what circumstances self-interest is objectionable.

III. WHEN IS SELF-INTEREST OBJECTIONABLE?

a. Expectation or access for unilateral benefit

Liability for breach of loyalty by any fiduciary is strict. Yet the court's broad definition of when the duty will be owed does not clearly identify those situations where self-regard is objectionable. Using the purpose of the duty this can help identify those circumstances and given the broad definition by the courts, academic commentary on the matter will be of particular importance.¹⁷⁰ Establishing when it is objectionable will show when a non-executive would be constrained by strict liability in multiple appointments.

One contention is that loyalty is owed where there is a reasonable expectation to it. If an individual undertakes responsibility to act for another's benefit, if there is a reasonable expectation that they will do so at the expense of their own interests loyalty will be imposed. As Finn argued 'the circumstances may generate an actual expectation that the other's interests are being served'.¹⁷¹ There can be no loyalty where there is no reasonable

¹⁷⁰ See, M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010) 245

¹⁷¹ M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010) 63; citing P Finn, 'The fiduciary principle' in T Youdan (ed), *Equity, Fiduciaries and Trusts* (Carswell, 1989) 47

expectation to it because it would be unreasonable to expect an individual to suspend self-regard when there was never the intention to act for the benefit of the other. Cases have emphasised the necessity that the fiduciary undertakes to act for the benefit of the principal for there to be a reasonable expectation to loyalty. Millet's LJ statement that 'a fiduciary is someone who undertakes to act for or on behalf of another...' ¹⁷² has been recognised in several cases. ¹⁷³

Yet the requirement that the individual acts for the benefit of another is not peculiar to a fiduciary relationship as Conaglen points out.

Many contractual arrangements effectively allow the parties a choice – discretion – as to the mode of performance they adopt, where differing modes can be more or less beneficial to the performing party, and yet it is not suggested that they owe fiduciary obligations as a result. ¹⁷⁴

Millet's LJ statement that one must undertake to act for the benefit of another also required that undertaking to be based on trust and confidence. In a sense the principal must be vulnerable to the fiduciary. Edelman has sought to come to the defence of reasonable expectation thesis. He argues that where there is a voluntary undertaking of responsibility, either contractual or non-contractual, the reason the duty arises is similar to implied terms in contracts. 'Terms such as an undertaking of care and skill will be implied into the undertaking, unless the circumstances show that the parties could not reasonably be taken

¹⁷² *Bristol and West Building Society v Mothew* [1998] Ch. 1, 18

¹⁷³ See, for example, *City of London Group plc v Lothbury Financial Services Ltd* [2012] EWHC 3148 (Ch) at [55]; *Al Khudairi v Abbey Brokers Ltd* [2010] EWHC 1486 (Ch) at [114]; *Conway v Ratiu* [2005] EWCA Civ 1302; [2006] 1 All E.R. 571 at [57]; M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010) 258

¹⁷⁴ See, M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010) 248

to have intended to include such a term.¹⁷⁵ He continues that 'the greater the degree of trust, vulnerability, power and confidence reposed in the fiduciary, the more likely the reasonable person would have such an expectation'.¹⁷⁶ This line of argument may see support from employee cases of fiduciary relationships. An employee is generally not in a fiduciary relationship with the employer because the balance of power was with the employer. Only in exceptional circumstances will the employee be in a fiduciary position because the employer's interests are entrusted to the employee's care.¹⁷⁷

It is not considered clearly at what point one would be reasonably entitled to expect loyalty where one does act for another at the expense of their own self-interest. The claim that duty arises where there is a reasonable expectation that the fiduciary acts for the benefit of the principal as they are vulnerable, does little to identify the situations where loyalty will be expected in any particular relationship. Edelman's contention that there must be a voluntary undertaking to give rise to the reasonable expectation also lacks precision since not all contractual and non-contractual voluntary undertakings necessarily require the individuals involved to suspend any self-interest. Such an encompassing definition could make non-traditional fiduciary relations fiduciary if one simply establishes that it is reasonable to do so. As Millet LJ noted not everything the fiduciary does will be capable of being a breach of fiduciary liability.¹⁷⁸ Flannigan has also been critical of cases where the judge has contended directors have breached their duty of loyalty where the director failed to act in the best interests of the company and for a proper purpose where the director's actions were not

¹⁷⁵ J Edelman, 'When do fiduciary duties arise?' (2010) 126 LQR 302, 313

¹⁷⁶ J Edelman, 'When do fiduciary duties arise?' (2010) 126 LQR 302, 317

¹⁷⁷ See, for example, *IG Index plc v Colley & Ors* [2013] EWHC 478 (QB); *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769; *Caterpillar Logistics Services (UK) Ltd v Huesca de Crean* [2012] EWCA Civ 156; [2012] 3 All E.R. 129; *Caterpillar Logistics Services (UK) Ltd v Huesca de Crean* [2011] EWHC 3154 (QB); *University of Nottingham v Fishel* [2000] I.C.R. 1462

¹⁷⁸ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 18

tainted with self-interest.¹⁷⁹ The lack of a precise circumstance when loyalty will be owed is the main reason for criticism of such an approach. Basing when the duty arises upon a reasonable expectation is too broad by itself and fails to clarify who is subject to the regulation.¹⁸⁰ Kershaw supports this by contending that this may result in over-inclusive application if the limits of fiduciary jurisdiction are not readily defined.¹⁸¹ Conaglen has suggested that the thesis by itself 'states little more than that fiduciary duties arise whenever it is appropriate to apply them',¹⁸² although he maintains that 'the court's ... insistence on retaining flexibility as to when fiduciary duties arise, tend to mean that the legitimate expectations [reasonable expectations] approach is the only one likely to be accurate'.¹⁸³

Reasonable expectation by itself still does not acknowledge what situations the principal would be entitled to expect loyalty. In what situations would someone be vulnerable enough for the court to impose fiduciary duties is not clearly answered but it is clearly part of why the duty is owed to the principal. 'The concept of vulnerability is not the hallmark of fiduciary relationship though it is an important *indicia* of its existence.'¹⁸⁴ Edelman's approach still seems to be of the view that fiduciary duties are imposed when it is reasonable to do so because the principal is vulnerable without identifying those situations where someone is entitled to expect loyalty. It suggests a threshold that needs to be met, that the principal must

¹⁷⁹ R Flannigan, 'Fiduciary duties of shareholders and directors' (2004) *Journal of Business Law* 277; for a recent example of this confusion see, *ODL Securities Ltd v McGrath* [2013] EWHC 1865

¹⁸⁰ R Flannigan, 'Access or Expectation: The test for fiduciary accountability' (2010) 89(1) *The Canadian Bar Review* 1, 10

¹⁸¹ D Kershaw, 'Does it matter how the law thinks about corporate opportunities' (2005) 25(4) *LS* 533, 539

¹⁸² M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010) 260

¹⁸³ M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010) 254-5

¹⁸⁴ *Hodgkinson v Simms* [1994] 3 S.C.R. 377, 405

demonstrate a certain degree of vulnerability for the duty to be imposed; yet the notion of the duty is based on whether or not someone undertakes to act for the benefit of another, which suggests a binary approach that either they did or did not agree to act for the principal's benefit rather than a certain degree of trust being required. As DeMott suggests, 'a plaintiff's expectation of loyal conduct may be justifiable even when the plaintiff has some basis to doubt whether an actor will fulfil that expectation'.¹⁸⁵ The concept of imposing loyalty based on a reasonable expectation can be conceptually vague and as Kershaw identified that if it is applied it may result in over-inclusive application where self-regard is not objectionable.

Keeping the purpose of the duty in mind is to regulate self-interest allows Flannigan to identify those situations where self-interest would be objectionable and when the duty should be imposed. According to Flannigan the need for flexibility is no ground to defend or justify the test of reasonable expectation.¹⁸⁶ Flannigan postulates that limited access arrangements, where one undertakes to act wholly or partly for the interests of another,¹⁸⁷ are those that will give rise to fiduciary obligations because in such arrangements the individual will 'invariably acquire access to the assets (and opportunities) of their beneficiaries. The mischief associated with that access is that the value of the assets will be diverted or exploited for self-interested ends'.¹⁸⁸ Limited access arrangements are more than an individual being given discretion for another, but they are given discretion to act for that other person's benefit at the expense of all others. Flannigan emphasises the need for an undertaking to solely benefit another to characterise a fiduciary relationship in the example of an easement holder and co-owners:

¹⁸⁵ D DeMott, 'Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences' (2006) 48 *Arizona Law Review* 925, 938

¹⁸⁶ R Flannigan, 'Access or Expectation: The test for fiduciary accountability' (2010) 89(1) *The Canadian Bar Review* 1, 3

¹⁸⁷ R Flannigan, 'The Boundaries of Fiduciary Accountability' (2004) *New Zealand Law Review* 215, 216

¹⁸⁸ R Flannigan, 'The Boundaries of Fiduciary Accountability' (2004) *New Zealand Law Review* 215, 216

Holders secure some right of access for their benefit, not the benefit of the owner of the burdened property... There is no undertaking to use the right to benefit the owner of the property... Easement holders who encroach on the subject property beyond their easement rights are in the same position as strangers. Their conduct does not involve a fiduciary breach because they do not have access pursuant to an undertaking to serve the interests of the owner.¹⁸⁹

Flannigan considers then fiduciary jurisdiction is restricted to limited access arrangements because where there is no access there can be no opportunistic diversion; or where there is open access 'consumption or exploitation does not amount to objectionable self regard',¹⁹⁰ because the use of the property is to benefit the individual and not the owner of the burdened property.¹⁹¹ Flannigan uses the example of how a relationship may be characterised by both open access and limited access in the form of mortgagees that serves to highlight the distinction.

Mortgagors charge property to secure the monies they borrow. They grant rights to their mortgagees to sell the charged property. Those rights are conveyed to mortgagees for *their* benefit. Accordingly, as an open access, that dimension of the mortgage relation has no fiduciary character. Mortgagees may during the term of the mortgage harbour undisclosed interests that are in conflict or competition with the interests of mortgagors. Mortgagees are also entitled to transfer their mortgage interest to whomever they wish for whatever benefit they can command. That does not, however, end the issue of fiduciary accountability. An obvious status accountability arises with respect to the personal information that mortgagors convey to mortgagees in order to acquire funds. That information is confidential. It is

¹⁸⁹ R Flannigan, 'Access or Expectation: The test for fiduciary accountability' (2010) 89(1) *The Canadian Bar Review* 1, 11

¹⁹⁰ R Flannigan, 'The Boundaries of Fiduciary Accountability' (2004) *New Zealand Law Review* 215, 216-7

¹⁹¹ R Flannigan, 'Access or Expectation: The test for fiduciary accountability' (2010) 89(1) *The Canadian Bar Review* 1, 10

provided for the limited purpose of establishing identity and creditworthiness. It would be a fiduciary breach for mortgagees to exploit the information for unauthorized gain.¹⁹²

Where an individual undertakes responsibility for another's unilateral benefit, it is in these situations that the principal will be entitled to loyalty because of the prophylactic concerns in limited access arrangements. It is in these situations that the principal is in a vulnerable position and trusts the fiduciary. Characterising fiduciary loyalty based on reasonable expectation alone cannot clearly identify when someone is subject to the regulation because self-regard is not always objectionable where one agrees to act another and so reasonable expectation does not clearly identify who is subject to the regulation. Limited access identifies those situations where self-regard is objectionable because the fiduciary undertakes responsibility for the benefit of the principal at the expense of all others. The principal is vulnerable to the fiduciary in these limited access arrangements, as they trust them to use the access for their unilateral benefit but this is a consequence of the access and not a cause of the relationship. Where the individual does not have access for the other's unilateral benefit, or has open access, the prophylactic concerns are removed because self-regard is not objectionable.

This approach, that loyalty is owed where it is evidenced that access was granted for a limited purpose of unilaterally benefitting the principal, seems most consistent with the case law and provides more certainty as to when a principal will be entitled to loyalty. However, it should be noted first applying the theories to most of these cases the same result could probably be reached, and the emphasis is more on how that result is achieved. In *University of Nottingham v Fishel*, for example, Elias J drew a clear distinction between an employee's

¹⁹² R Flannigan, 'Access or Expectation: The test for fiduciary accountability' (2010) 89(1) *The Canadian Bar Review* 1, 12

duty of fidelity and a fiduciary duty of loyalty to demonstrate when the latter is owed. He considered that the duty of fidelity is owed by all employees but:

In determining whether a fiduciary relationship arises in the context of an employment relationship, it is necessary to identify with care the particular duties undertaken by the employee, and to ask whether in all the circumstances he has placed himself in a position where *he must act solely in the interest* of his employer. It is only once those duties have been identified that it is possible to determine whether any fiduciary duty has been breached.¹⁹³ (emphasis added)

Elias J makes clear that it needs to be evidenced that the individual undertook responsibility to act for the sole benefit of the principal for the duty to be owed and not simply because it was reasonable to impose it or the fact they were vulnerable. Therefore certain relationships such as debtor-creditor would not generally be considered to give rise to loyalty because the access granted to the debtor is not for the unilateral benefit of the creditor.¹⁹⁴ In *Pfeiffer (E) Weinkellerei Weinenkauf GMBH and Co v Arbuthnot Factors Ltd* the judge found no fiduciary relationship existed between the debtor and creditor because evidence was inconsistent with the proposition from the plaintiff that the defendant was only authorised to sell the product for the account of the plaintiff.¹⁹⁵ The defendant then had never agreed that the taking of the property was for the benefit of the plaintiff and so it would have been unreasonable for the plaintiff to expect the defendant was loyal. In *Hospital Products v US Surgical Corporation* it was also recognised that a distributor would take decisions in their own interests.¹⁹⁶ In both situations no fiduciary relationship arose because the access granted was not just for the

¹⁹³ *University of Nottingham v Fishel* [2000] I.C.R. 1462, 1494

¹⁹⁴ See, for example, *Re Curtain Dream plc* [1990] B.C.C. 341; *Pfeiffer (E) Weinkellerei Weinenkauf GMBH and Co v Arbuthnot Factors Ltd* [1988] 1 W.L.R. 150 *cf.* *Aluminium Industrie Vaassen BV v Romalpa* [1976] 1 W.L.R. 676

¹⁹⁵ *Pfeiffer (E) Weinkellerei Weinenkauf GMBH and Co v Arbuthnot Factors Ltd* [1988] 1 W.L.R. 150, 160

¹⁹⁶ *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 C.L.R. 41

unilateral benefit of the principal. The individual had not suspended his or her own personal interests in these circumstances and so self-regard was not objectionable. In the debtor-creditor relationship the creditor is not necessarily vulnerable to the debtor as the access is not for the creditor's benefit. The access was so the debtor could sell on his or her own account and so self-regard was not objectionable as the prophylactic concerns were removed.

Conversely, in *Lac Minerals Ltd v International Corona Resources Ltd* it was seen that whilst commercial negotiations were not traditionally fiduciary in nature as they are conducted at arms-length for each party's own benefit; but on the facts the information received by one party that belonged to the other in relation to the joint venture could not be used for its exclusive benefit.¹⁹⁷ Here the principal was entering in to a joint venture with the fiduciary regarding the extraction of minerals from fields. The principal sent information to the fiduciary regarding an adjacent field that they believed to have minerals. The fiduciary then put in a successful competing bid against the principal. The information received was for the limited purpose of benefiting the joint venture. Granting access made the principal vulnerable to the fiduciary that it would only be used to benefit the joint venture. The access to the information could not be used for the fiduciary's own benefit because there was a risk they would not have pursued their obligations to the joint venture properly. It was not simply the case that it was reasonable to impose fiduciary duties, but in the situation there was clear evidence the information received by the fiduciary was for the limited purpose of benefiting the joint venture and in those situations the principal is vulnerable and the prophylactic concerns are present. Therefore it is only reasonable to impose duties in those situations. Edelman's suggestion that there needs to be a certain degree of trust and vulnerability cannot be maintained as a determinant for imposing duties by itself. The correct approach is that there is vulnerability because the fiduciary is granted access for the sole benefit of the principal. If

¹⁹⁷ *Lac Minerals Ltd v International Corona Resources Ltd* [1990] F.S.R. 441, 444, 459

an approach based only on reasonable expectations, or reasonable expectations in voluntary undertakings, will mean courts may continue to apply the fiduciary concept without consideration of whether it truly applies in the circumstances. For example, in *ODL Securities Ltd v McGrath* the court maintained a legal risk officer had breached his fiduciary duty to the company but based their reasoning on the fact his position was analogous to a director¹⁹⁸ without considering whether the individual had undertaken responsibility to act for the unilateral benefit of the company. Even if such a conclusion was reached the court continued that the individual breached their fiduciary duty despite most of the complaints by the company not involving self-interested transactions on the facts but rather negligence and bad faith.¹⁹⁹ Maintaining fiduciary duties are owed purely on the basis of reasonable expectations continues to obscure in what situations the duty should be owed so as to fulfil the purpose of removing the prophylactic concerns in a relationship where one acts for the unilateral benefit of another.

Determining fiduciary relationships where one acts for the unilateral benefit of another will accurately identify those situations classified as fiduciary. Therefore in the Court of Appeal's judgment in *Sinclair Investment Holdings v Versailles Trade Finance*²⁰⁰ found fiduciary accountability for a *de facto* director to an investor who had continued his investment upon the undertaking by the director. The company used the investment to artificially enhance the value of shares in an associated company, which the director personally profited from by selling his shares. The access to the investment was undertaken for the sole of benefit the investor. Using the access to the investment for personal gain meant there was great temptation he would not perform his functions undertaken to the investor properly. Similar, in *Boardman* the beneficiary declined to take extra shares in a company despite advice from

¹⁹⁸ *ODL Securities Ltd v McGrath* [2013] EWHC 1865 at [17]

¹⁹⁹ *ODL Securities Ltd v McGrath* [2013] EWHC 1865 at [103]-[113]

²⁰⁰ *Sinclair Investment Holdings v Versailles Trade Finance* [2005] EWCA Civ 722; [2006] 1 B.C.L.C. 60

the solicitor to do so. The solicitor then took them personally. The solicitor was accountable as a fiduciary and was liable for a breach of the duty of loyalty. The access to the trust property and its affairs was for the benefit of the beneficiaries and not for the personal benefit of the fiduciary. By using that access for personal benefit there was the temptation not to perform their functions properly to the beneficiaries.

IV. CONSEQUENCES FOR NON-EXECUTIVES

The consequences of the analysis for non-executive directors are that in being granted limited access to the company's property and affairs there will be a duty of loyalty and subsequent fiduciary relationship because there is the concern that they may use that access for their own benefit. That duty would therefore include being prevented from competing with the company because access is granted for the sole benefit of the principal. If the access granted is allowed to be used for the non-executive to compete with the company there would be the temptation that the non-executive would not perform their function for the benefit of the principal because of their self-interest elsewhere. This was highlighted in *Pyke*, that there is the risk the director may use their board influence to benefit themselves in their other appointment. That temptation is regulated by strict liability regardless of whether the interest is personal or for a third party. It was wrong in *Cambridge* to contend that the non-executive would not be prevented from competing with the company because where there is limited access for the unilateral benefit of another the duty will be owed and any risk of conflict will be prohibited unless otherwise authorised. Loyalty is the generic feature of a fiduciary obligation and where it is owed the duty removes the risk of self-interest regardless of whether the individual is an executive or non-executive.

This means fiduciary liability is a potential way of helping to align the interests of the non-executive with the company's interests because where they have limited access, i.e. for the unilateral benefit of the principal, they will be required to observe the duty of loyalty and treat

their own or third party interests as subservient. The non-executive must have no personal interest in the property or affairs of the company outside the performance of his functions without authorisation, otherwise there is the risk he or she will not perform them properly. They will be deterred *ex post* from not acting for the benefit of their principal where they have limited access as they will be liable to disgorge any profit made on the conflict. Once it has been determined that the individual undertook responsibility to act solely in the interests of his principal it is possible to determine when the duty of loyalty is breached.²⁰¹ Chapter III will now consider to what extent the fiduciary must be loyal when it is demonstrated that they were granted access for the sole benefit of the principal.

²⁰¹ *University of Nottingham v Fishel* [2000] I.C.R. 1462, 1494

Chapter III

Unlimited fiduciary capacity? The scope of fiduciary liability for non-executive directors

*Tutor rem pupili emere non potest; idemque porrigendum est ad similia, id est, ad curatores, procuratores, et qui negotia aliena gerunt.*²⁰²

I. LIABILITY FROM THE PERSPECTIVE OF THE FIDUCIARY

A non-executive will owe the fiduciary duty of loyalty since the company grants access for its sole benefit. A director, executive or non-executive, during their tenure, will encounter several business opportunities, especially where they serve for more than one principal. However, owing a duty of loyalty to multiple principals may mean there is a potential conflict between whose interests they prefer when presented with an opportunity and the director will be unable to treat both principals' interests as subservient. Looking at the scope of fiduciary liability for directors will help determine when they can pursue an opportunity for one principal without breaching the duty to the other. This will show when the duty acts as an *ex post* form of control to deter the non-executives from acting against the interests of the company when owing a duty to multiple principals. Therefore this chapter sets out to investigate the scope of liability by looking at what interests the non-executive is meant to be loyal to. Since the previous chapter considered interest-duty and duty-duty conflicts to be fulfilling the same purpose this analysis can be applied in both contexts.

If an individual is determined to be in a fiduciary relationship and must be loyal to the interests of the principal, it needs to be assessed what interests of the principal they must be loyal to. It is generally accepted that fiduciary liability is circumscribed by contract because

²⁰² *Aberdeen Rail v Blaikie Brothers* [1843-60] All E.R. Rep. 249, 254; "A tutor cannot buy a thing belonging to his ward; this rule extends to other persons with similar responsibilities, that is curators, procurators and those who conduct another's affairs."

‘equity cannot alter the terms of the contract validly undertaken’.²⁰³ It was explained in *Kelly v Cooper* that ‘the existence and scope of these duties depends on the terms on which they are acting’.²⁰⁴ Fiduciary duties will attach themselves to the terms of the agreement but they ‘cannot be superimposed upon the contract in such a way as to alter the operation which the contract was intended to have according to its true construction’.²⁰⁵ This means you are only loyal for what you took responsibility for and there can be no reasonable expectation to loyalty beyond that. The liability of a fiduciary cannot extend beyond that because there needs to be something from which the duty can be “hung from”.²⁰⁶ Whilst fiduciary proscriptions are generic, the situations they apply depend on the responsibility undertaken to the principal.²⁰⁷ Therefore, in principle, it is possible for a fiduciary to take on multiple appointments and even act against the principal on matters not retained for²⁰⁸ because there is no access granted at one firm to allow for any opportunistic diversion.²⁰⁹ A non-executive on this basis would be prevented from competing with their principal on any matter retained for.

However, Rimer LJ in *Re Allied Business & Financial Consultants Ltd*²¹⁰ declared that whilst a partner’s fiduciary duty may be circumscribed by the partnership agreement, as it was in

²⁰³ *University of Nottingham v Fishel* [2000] I.C.R. 1462, 1491

²⁰⁴ *Kelly v Copper* [1993] A.C. 205, 214

²⁰⁵ *Kelly v Copper* [1993] A.C. 205, 215; citing *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 C.L.R. 41, 97

²⁰⁶ *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769 at [68]

²⁰⁷ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 18; *Henderson and Others v Merrett Syndicates Ltd and Others* [1995] 2 A.C. 145, 205; *New Zealand Netherlands Society “Oranje” Inc v Kuys* [1973] 1 W.L.R. 1126, 1130; *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [80]

²⁰⁸ *Boardman v Phipps* [1967] 2 A.C. 46, 126

²⁰⁹ cf. *Bolkiah v KPMG* [1999] 2 A.C. 222; *Marks & Spencer plc v Freshfields Bruckhaus Deringer* [2004] EWCA Civ 741; [2005] P.N.L.R. 4

²¹⁰ *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822

Aas v Benham,²¹¹ ‘a trustee’s and director’s fiduciary duties are not similarly circumscribed by the terms of contract’.²¹² Rimer LJ was following Lord Hodson’s decision in *Boardman v Phipps* that directors stood in a “general fiduciary position” because the limits were not readily defined.²¹³ This is because, unlike a partnership agreement where the nature of business is ‘expressly limited by the terms of the partnership agreement’,²¹⁴ the constitution of the company is not so. A company’s constitution will generally have unrestricted objects²¹⁵ and so the scope of the company’s business is ‘in no manner relevantly circumscribed by its constitution’.²¹⁶ On this basis Rimer LJ continued that directors have “unlimited fiduciary capacity”²¹⁷ meaning where one acts for the unilateral benefit of another the reasonable expectation to loyalty is open-ended.

The suggestion that directors have unlimited fiduciary capacity based on the open-ended nature of the company’s interests would certainly prevent any self or third party interest but it would make holding multiple appointments untenable. Any corporate opportunity pursued for one principal would be in conflict with the duty owed to another because both would be deemed to be interested in the opportunity and the director has failed to treat other interests as subservient to that of one of his principal’s interest. This would be an unlikely and undesired conclusion based on the perceived benefits of multiple appointments from the judiciary, where Lord Upjohn believed it would be a “great pity” if such a conclusion was

²¹¹ *Aas v Benham* [1891] 2 Ch. 244

²¹² *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [68]

²¹³ *Boardman v Phipps* [1967] 2 A.C. 46, 65; cited by *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [69]

²¹⁴ *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [68]

²¹⁵ Companies Act 2006, s. 7(2)

²¹⁶ *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [69]

²¹⁷ *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [69]

reached,²¹⁸ legislators, where Baroness Noakes described them as a “reality of modern life”,²¹⁹ and economists, notably Fama and Jensen, who highlighted those with existing appointments had proven worth in the managerial labour market.²²⁰ This chapter intends to define the limits of a director’s fiduciary capacity, as set out in section 175(4)(a) of the Companies Act 2006 as a situation that cannot ‘reasonably be regarded as likely to give rise to a conflict of interest’, to determine when a director can legitimately pursue an opportunity for another principal. In doing so it will demonstrate when fiduciary liability acts as an *ex post* form of control and if this is suitable in preventing non-executive self-interest.

This chapter will investigate the scope of fiduciary liability. Using this analysis it can then be applied in the context of non-executive directors and multiple appointments. For a full analysis this chapter will also consider the scope of the duty post-resignation. This is because non-executives may take on alternate appointments after resignation or may continue to hold other appointments after resigning from one. In doing so they may act opportunistically before resignation from their role to avoid their obligation. This section will particularly take issue with a current trend that the supposed relaxation of fiduciary duties post-termination justifies liability based on what is fair, rather than the strict orthodox approach that was demonstrated in Chapter II. As with the last chapter the focus of the discussion will only be on conflicts of interest, and not self-dealing transactions, to investigate fiduciary liability for opportunities multiple principals are potentially interested in.

²¹⁸ *Boardman v Phipps* [1967] 2 A.C. 46, 128 – Lord Upjohn observed that it would be of “great pity” if all information learnt by a trustee in the course of their position became property of the trust because it would ‘make it difficult for private trustees to be trustees of more than one trust’.

²¹⁹ Hansard HL Vol 678, Official Report 6/2/06 Col GC288

²²⁰ E Fama and M Jensen, ‘Separation of Ownership and Control’ (1983) 26(2) *Journal of Law and Economics* 301, 315

II. THE SCOPE OF THE DUTY OF LOYALTY

When this duty is breached has been subject to numerous accounts of judicial and academic debate. The scope of the duty to a particular relationship is subject to diverging opinions but the difficulty with determining equitable principles can be summarised by the two opinions of Lord Upjohn and Harman LJ. Harman LJ expressed that:

Equitable principles are, I think, perhaps rather too often bandied about in common law courts as though the Chancellor still had only the length of his own foot to measure when coming to a conclusion. Since the time of Lord Eldon the system of equity for good or evil has been a very precise one, and equitable jurisdiction is exercised only on well-known principles.²²¹

Conversely, Lord Upjohn considered that ‘rules of equity have to be applied to such a great diversity of circumstances that they can be stated only in the most general terms and applied with particular attention to the exact circumstances of each case’.²²² Lord Goldsmith in the Grand Committee for the Companies Bill later cited these comments from Lord Upjohn, with approval.²²³

What was noted from the introduction was that the scope of duties in most fiduciary relationships extends only to those matters you were retained and the duty will be circumscribed at that point. This demonstrates, generally, that whilst the principal may be interested in a multitude of matters the principal is only entitled to loyalty for what a fiduciary takes responsibility for as otherwise there is nothing for the duty to be “hung from”. Therefore there is only a breach if the personal interest conflicts with the duty owed to, and not necessarily the interests of, the principal. This is in line with the purpose of the duty to remove the temptation of self-interest. If there is no responsibility undertaken then there is no function to fulfil and no risk that it will not be performed properly.

²²¹ *Campbell Discount Co Ltd v Bridge* [1961] 1 Q.B. 445, 459

²²² *Boardman v Phipps* [1967] 2 A.C. 46, 123

²²³ Hansard HL Vol 681, Official Report, 9/5/06 Col 863

This approach can be seen from existing academic opinion on the topic. Flannigan notes that ‘the starting point is necessarily the social function of fiduciary responsibility. The proper contours of regulation are determined by the nature of that function’.²²⁴ That function has already been discussed in Chapter II as regulating opportunism in limited access arrangements where one agrees to act for the unilateral benefit of another. Thus Flannigan contends that the contours of the duty extend only to that you were granted access because without access there can be no opportunistic diversion.²²⁵ Therefore the duty, according to Flannigan, is breached and the fiduciary liable where they prefer their own interests within the ‘ambit or confines of their limited access’.²²⁶ Upon this analysis a fiduciary granted access to a house to sell it for their principal is prevented from any opportunistic diversion based on that access.

Conaglen also offers support that the fiduciary duty is circumscribed by the duty undertaken. His thesis postulates that the duty is circumscribed by looking at the non-fiduciary duties of the fiduciary.²²⁷ He writes that the ‘the moulding of fiduciary duties to the circumstances of each case is to be found in the fact that non-fiduciary duties differ from case-to-case, because it is those non-fiduciary duties to which fiduciary doctrine offers its protection and to which fiduciary doctrine must necessarily respond’. He continues that ‘the scope of application of fiduciary duties necessarily depends in each case on the content and scope of the non-fiduciary duties owed in that case because ‘the conflicting duty or interests must be

²²⁴ R Flannigan, ‘The Boundaries of Fiduciary Accountability’ (2004) *New Zealand Law Review* 215, 215-6

²²⁵ R Flannigan, ‘The Boundaries of Fiduciary Accountability’ (2004) *New Zealand Law Review* 215, 217

²²⁶ R Flannigan, ‘The Boundaries of Fiduciary Accountability’ (2004) *New Zealand Law Review* 215, 218

²²⁷ M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010)

identified'.²²⁸ His analysis contends that the duties attach themselves to the performance of non-fiduciary duties. For example, a fiduciary who has a non-fiduciary duty to negotiate contracts for their principal has that duty regulated by the fiduciary duty to do so without self-interest.

Edelman's thesis, in this context, offers that loyalty is owed depending on whether it was implied in to the agreement and that 'the greater the degree of trust, vulnerability, power and confidence reposed in the fiduciary, the more likely the reasonable person would have such an expectation'.²²⁹ Edelman cites the case of *New Zealand Netherlands "Oranje" Society v Kuys* to show that whilst the individual was a fiduciary his actions were not a fiduciary breach because it fell outside the scope of fiduciary obligations undertaken. It would have been unreasonable for an individual to owe fiduciary obligations in circumstances that were not related to that which he had agreed to undertake responsibility for.²³⁰ This can be quite commonly seen in other cases of employee fiduciary duties.²³¹ In *Ranson*, for example, whilst the employee was said to be a fiduciary in respect of the territory he was employed in to pursue new opportunities, opportunities outside that territory had never been his responsibility.²³² In *University of Nottingham v Fishel* the employee did not agree to pursue all interests that fell within the University's scope of business.²³³ This thesis is, perhaps, more in line with Millet's LJ observation that not all actions by a fiduciary will necessarily be a

²²⁸ M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties*, (Hart Publishing, Oxford 2010) 179

²²⁹ J Edelman, 'When do fiduciary duties arise?' (2010) 126 LQR 302, 317

²³⁰ J Edelman, 'When do fiduciary duties arise?' (2010) 126 LQR 302, 320-1

²³¹ *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769; *Caterpillar Logistics Services (UK) Ltd v Huesca de Crean* [2011] EWHC 3154 (QB); *University of Nottingham v Fishel* [2000] I.C.R. 1462

²³² *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769 at [59]-[74]

²³³ *University of Nottingham v Fishel* [2000] I.C.R. 1462, 1496

fiduciary breach.²³⁴ Therefore it is not necessarily all the actions of the individual that will require loyalty. Loyalty will only be reasonably expected in respect of those matters retained to act for the sole benefit of the principal. Therefore reasonable expectation does have relevance in the context of fiduciary jurisdiction. Reasonable expectation can “mould” itself to any novel way of self-interest in respect of limited access.²³⁵ For example, in duty-duty conflicts, whilst a fiduciary may not have a duty in respect of confidential information about one principal held by the other, any use of it may be a fiduciary breach as their access has allowed them to advance another’s interests.²³⁶ Thus, it has been held to be a breach of fiduciary duty where an individual has benefitted personally by using their access to the principal in respect of property and affairs they had not taken responsibility for, or have some pre-existing duty in respect of, to obtain opportunities.

Whilst there are differences in the approaches taken by these commentators all three seem to appreciate that when loyalty is owed is not based on the principal’s interests but upon the responsibility undertaken by the fiduciary. The approach that a duty is circumscribed by contract and not what the principal does is supported by several cases.²³⁷ Therefore the extent to which one fiduciary owes the duty of loyalty may be different to another depending on the exact relationship they have with the principal’s interests. It was considered in *Fishel*,

²³⁴ *Bristol and West Building Society v Mothew* [1998] Ch. 1, 16

²³⁵ See, *New Zealand Netherlands Society “Oranje” Inc v Kuys* [1973] 1 W.L.R. 1126, 1130; *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [80]

²³⁶ See, for example, *Bolkiah v KPMG* [1999] 2 A.C. 222; *Marks & Spencer plc v Freshfields Bruckhaus Deringer* [2004] EWCA Civ 741; [2005] P.N.L.R. 4

²³⁷ See, for example, *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769; *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332; *University of Nottingham v Fishel* [2000] I.C.R. 1462; *Kelly v Copper* [1993] A.C. 205; *Faccenda Chicken Ltd v Fowler* [1987] Ch. 117; *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 C.L.R. 41; *New Zealand Netherlands Society “Oranje” Inc v Kuys* [1973] 1 W.L.R. 1126;

for example, that whilst the duty in a partnership or joint venture may be circumscribed by the scope of the business undertaken the same could not be said for an employee's fiduciary duty because:

Such persons are undertaking to share the work which falls within the scope of the partner or joint venture. The same principle cannot simply be treated as being automatically applicable in the very different context of the employment relationship. The employee does not in general promise to give his employer the benefit of every opportunity falling within the scope of its business.²³⁸

Given Rimer's LJ judgment that directors have unlimited fiduciary capacity based on the open-ended nature of the constitution, it needs to be considered when exactly, if at all, the director is required to be loyal and if this is satisfactory in ensuring the non-executive acts for the benefit of the principal.

a. Is liability circumscribed by the company's scope of business?

One contention as to how the duty can be circumscribed is by applying a scope of business test. The test contends, generally, that the duty is circumscribed by what the company's current business is rather than what the company's business could potentially be. This test was rejected by Rimer LJ in *Re Allied Business* and seemingly by the intentions of Parliament²³⁹ but has received approval from academic commentators such as Lim²⁴⁰ and Kershaw.²⁴¹ Lim has contended that directors, like partners, have their duty circumscribed by contract since Lindley LJ in *Aas* looked at the circumstances as well as the partnership

²³⁸ *University of Nottingham v Fishel* [2000] I.C.R. 1462, 1496; see also, *Caterpillar Logistics Services (UK) Ltd v Huesca de Crean* [2011] EWHC 3154 (QB)

²³⁹ Hansard HL Vol 681, Official Report, 9/5/2006, col 863-866

²⁴⁰ E Lim, 'Directors' fiduciary duties – A new analytical framework' (2013) 129 LQR 242

²⁴¹ D Kershaw, 'Does it matter how the law thinks about corporate opportunities' (2005) 25(4) LS 533

agreement, whereas Rimer LJ only referred to the latter when considering *Aas*.²⁴² Lim submits directors' and partners' duties are similar insofar that there is an expectation that they behave in a similar way and that the company's scope of business can be determined by looking at relevant corporate documents which will identify the circumstances the director agreed to act.²⁴³ Kershaw offers another proposition to support the scope of business test. He believed the approach in *Aas* is 'epistemologically consistent with the no-conflicts approach but articulates more clearly what remains implicit in the no-conflicts approach'.²⁴⁴ By this he means opportunities can be viewed through a property-type lens that allows the company to exclude the director from pursuing the opportunity personally that fall within the company's scope of business.²⁴⁵ He contends that the scope of business test is consistent with the strict orthodox approach and the test does not consider any fairness facts.²⁴⁶ He argues this is because it can be easily ascertained what is within the company's scope of business.

The genesis of the test derives from the case of *Aas*. The material facts of the case were that a partner for a ship-broking business obtained information to an opportunity, during the course of his functions as a partner, to advise a company on the construction of the ships. It was held there was no conflict as the advice to the company fell outside the scope of business of the partnership, which was identified looking at the partnership agreement.

This test was argued in *Re Allied Business* where the objects of the company were usually focused on arranging commercial loans and occasionally arranging some residential

²⁴² E Lim, 'Directors' fiduciary duties – A new analytical framework' (2013) 129 LQR 242, 253; citing *Aas v Benham* [1891] 2 Ch. 244, 254

²⁴³ E Lim, 'Directors' fiduciary duties – A new analytical framework' (2013) 129 LQR 242, 253

²⁴⁴ D Kershaw, 'Does it matter how the law thinks about corporate opportunities' (2005) 25(4) LS 533, 536

²⁴⁵ D Kershaw, 'Does it matter how the law thinks about corporate opportunities' (2005) 25(4) LS 533, 549

²⁴⁶ D Kershaw, 'Does it matter how the law thinks about corporate opportunities' (2005) 25(4) LS 533, 554-5

mortgages although not specifically restricted as such. The two dominant members of the company, S and L, were approached by P to find a buyer for a property from clients of the company. Originally W was interested in purchasing the property and negotiations began. W then dropped out of the transaction. S and L found another buyer H, who was willing only to take a 50% stake if S and L took the remaining 50% as he knew they had experience in property development. S and L then became personally interested in the transaction, with the company becoming £30,000 worse off as a vendor's commission fee would not be acquired, but more than that the opportunity was diverted away from the company. This is despite the fact it was established the company could neither afford it nor was willing to enter in to it, due to the claimant and third member O, being reluctant to enter in to such a venture. The court of first instance found no breach as it was seen that the venture was outside the company's scope of business. The Court of Appeal reversed that decision finding that they were in conflict because they received the information in the course of their directorships.²⁴⁷ They went on to establish that this opportunity was inside the company's scope of business²⁴⁸ but that the law did not recognise such a test. 'The authorities relating to directors' accountability not only do not support the 'scope of business' exception ... they are contrary to it. They show that the principle is a rigorous one.'²⁴⁹ What this means is Rimer's LJ comments were *obiter dicta* but his detailed rejection requires consideration.

The rejection of the test seems to be based on the point mentioned above that the scope of business test should be rejected because the constitution is open to any business and thus the duty cannot be circumscribed. The company was open to engage in property development if it so chose.²⁵⁰ Rimer LJ continued that:

²⁴⁷ *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [54]

²⁴⁸ *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [51]

²⁴⁹ *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [55]

²⁵⁰ *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [69]

It is not for the director to make his own decision that the company will not be interested and to proceed, without more, to appropriate the opportunity for himself. His duty is one of undivided loyalty and this is one manifestation of how that duty is required to be discharged.²⁵¹

Such a statement has previous support in *Cook v Deeks*, where it was held that it is not for a director to unilaterally decide what a company is or is not interested in.²⁵² Rimer LJ continued that:

It may have been improbable that the company could or would want or be able to take up the opportunity itself. But the opportunity was there for the company to consider and, if so advised, to reject and it was no answer to the claimed breach of the 'no profit' rule that property investment was something that the company did not do... There was no bright line marking off what it did and did not do.²⁵³

However another reason why the scope of business test must be doubted and be seen as inconsistent with fiduciary regulation and those arguments that support it, is a reason why there is an imperfection in Rimer's LJ reasoning. Rimer LJ was correct to observe that it is not for the director to decide what the company is or is not interested in because its interests are undefined unlike in a partnership or joint venture; but his justification for stating the fiduciary duty of a director cannot be circumscribed based on the constitution being open ended looks at what the principal does and this is opposed to the premise that the duty is circumscribed based on the fiduciary's duty. Just because the constitution is open to any business does not justify a director having unlimited fiduciary capacity because it does not automatically follow that they take responsibility for everything the company is potentially interested in. This applies equally to those who support the scope of business test because it may not cover what the director takes responsibility for. This approach can be seen in the

²⁵¹ *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [70]

²⁵² *Cook v Deeks* [1916] 1 A.C. 554 (PC), 563

²⁵³ *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [71]

wording of Elias' J judgment in *Fishe* that liability will be different for fiduciaries in each specific context. The judgment articulates that the difference between potential fiduciary liability for each individual was not because the principal's interests were necessarily different but because partners or joint ventures 'are undertaking to share the work which falls within the scope of the partner or joint venture ... The employee does not in general promise to give his employer the benefit of every opportunity falling within the scope of its business'.²⁵⁴ Elias J makes clear that it is the specific undertaking of the partner or joint venture that circumscribed the duty and not the interests of the partnership or joint venture.

Company law authorities do indeed exist that support the notion that directors, like other fiduciaries, have the duty circumscribed by what they take responsibility for. The judgment given by Sedley LJ in *Plus Group Ltd v Pyke*²⁵⁵ was recent approval of this but was not considered by Rimer LJ in *Re Allied Business*. In *Pyke*, Sedley LJ observed that, 'the fiduciary duty of a director to his company is uniform and universal. What vary infinitely are the elements of fact and degree which determine whether the duty has been breached'.²⁵⁶ This is clear approval from the Court of Appeal that the duty will be circumscribed based on the undertaking of the director. Here a director was allowed to compete with another company he was director of on the basis his fiduciary obligation was nominal as his role was nothing more than a name on paper.²⁵⁷ Lord Wilberforce has also stated that the duty is 'moulded according to the nature of the relationship ... the subject matter over which the

²⁵⁴ *University of Nottingham v Fishel* [2000] I.C.R. 1462, 1496; cited with approval in *Helmet Integrated Systems Ltd v Tunnard* [2006] EWCA Civ 1735; [2007] F.S.R. 16 at [37] *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769 at [43]

²⁵⁵ *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332

²⁵⁶ *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [80]

²⁵⁷ *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [90]; see also, *London and Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd* [1891] W. N. 165; *Framlington Group plc v Anderson* [1995] 1 B.C.L.C. 475; [1995] B.C.C. 611

fiduciary obligations extend is determined by the character of the venture or undertaking'.²⁵⁸ The Supreme Court in *Revenue and Customs Commissioners v Holland*²⁵⁹ and *Bath v Standard Land Co Ltd*²⁶⁰ have also offered support for the notion that directors are only accountable for what they undertake responsibility to do. In *Bath* it was established that a director was not responsible for his principal's own undertaking. Generally 'directors are in a fiduciary relation to the company, but not to a stranger with whom the company is dealing'.²⁶¹ The Supreme Court in *Holland* implicitly approves of *Bath* since it acknowledged that modern cases concerning *de facto* directors require an assumption of responsibility. In the appellate history the Court of Appeal rejected that an individual was a *de facto* director²⁶² of his principal's own undertaking as a corporate director simply because they were the individual who controlled the corporate director. The Supreme Court then refused to extend the concept to such individuals on the basis, *inter alia*, that the modern cases required an assumption of responsibility.²⁶³

Here it is considered then that if the fiduciary duty is circumscribed by what you take responsibility for then, without clear justification to the contrary, a director's fiduciary duty must be circumscribed in the same way. If the purpose of the duty is to remove self-interest from the performance of one's responsibility the fiduciary duty of a director must be circumscribed by that responsibility as well so as to avoid it being oppressive in its

²⁵⁸ *New Zealand Netherlands Society "Oranje" Inc v Kuys* [1973] 1 W.L.R. 1126, 1130

²⁵⁹ *Revenue and Customs Commissioners v Holland* [2010] UKSC 51; [2010] 1 W.L.R. 2793

²⁶⁰ *Bath v Standard Land Co Ltd* [1911] 1 Ch. 618, CA

²⁶¹ *Bath v Standard Land Co Ltd* [1911] 1 Ch. 618, CA, 625

²⁶² For *de facto* directors see, *Re Canadian Land Reclaiming and Colonizing Co* (1880) LR 14 Ch D 660; *Morris v Kanssen* [1946] A.C. 459 – those who receive faulty appointment; *Re New Par Consols Ltd* [1898] 1 Q.B. 573 – those continuing to serve after retirement; *Re Lo-Line Electric Motors Ltd* [1988] Ch. 477 – those who are never appointed at all but assume responsibility for the company

²⁶³ *Revenue and Customs Commissioners v Holland* [2010] UKSC 51; [2010] 1 W.L.R. 2793 at [96]

application. It is considered that this is what section 175(4)(a) of the Companies Act 2006 codifies as situations that cannot reasonably be regarded as likely to give rise to a conflict. Therefore, whilst section 175(1) refers to conflicts between personal interest and the company's interests i.e. everything, section 175(4)(a) circumscribes that duty to avoid such situations at the point of what you undertake responsibility for. Situations beyond that cannot reasonably be regarded as likely to give rise to a conflict.

This means a director may pursue opportunities outside of their responsibility and compete against the company if that competition was outside their responsibility to one principal. To discover the scope of a director's fiduciary responsibility there must be an investigation in to what they assumed responsibility for. The danger of applying the notion that directors have unlimited fiduciary capacity on the basis of the company's constitution or that liability is circumscribed by the scope of business is that it may result in an over or under inclusive application of their responsibility. It would be unreasonable and even oppressive to expect loyalty outside of one's obligations.²⁶⁴ The implication that their duty is unlimited would mean that a director's fiduciary liability has gone disproportionately beyond their responsibility.

III. WHAT DO DIRECTORS ASSUME RESPONSIBILITY FOR?

Determining the scope of the duty based on what the fiduciary takes responsibility for when granted access may be more difficult in certain cases of fiduciary relationships such as directors. In instances of solicitors,²⁶⁵ partners²⁶⁶ or employees²⁶⁷ there may be a contractual

²⁶⁴ *Hivac Limited v Park Royal Scientific Instruments Ltd* [1946] Ch. 169, 174

²⁶⁵ *Montesquieu v Sandys* (1811) 18 Ves 302, 313 (34 ER 331)

²⁶⁶ *Aas v Benham* [1891] 2 Ch. 244

²⁶⁷ *University of Nottingham v Fishel* [2000] I.C.R. 1462; *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769

document setting out what the respective responsibilities of the fiduciary were,²⁶⁸ although that contractual document may not be conclusive evidence and the judge may look at the circumstances such as was the case in *Aas*²⁶⁹ and *Ranson*.²⁷⁰ In these relationships there is likely to be a desired specific outcome with details on specific responsibility of the fiduciary. For directors the desired outcome is known but the means of achieving it are not. Their role and function is not set out by the Companies Act 2006 with section 250 giving only an inclusive definition of ‘anyone occupying the position of director, by whatever name called’, and the model articles tend to confer powers of general management on the directors.²⁷¹ Company law cases on *de facto* directors offer some guidance with phrases such as those who have “real influence over the corporate governance structure” used to identify those responsible as directors.²⁷² However, this may be of little assistance to a director assessing their responsibility and potentially liability.

What directors take responsibility for may differentiate. Generally an executive undertakes responsibility to advance the interests of the company that are open-ended because the objects of the company are unrestricted and it is not for the executive to unilaterally decide what the company is or is not interested in.²⁷³ Barnard identifies three key functions of the executive: The maintenance of the organisation; securing essential services from individuals;

²⁶⁸ See, *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769 at [34]; *Faccenda Chicken Ltd v Fowler* [1987] Ch. 117, 135

²⁶⁹ *Aas v Benham* [1891] 2 Ch. 244, 254

²⁷⁰ *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769 at [62]

²⁷¹ The Companies (Model Articles) Regulations 2008 (SI 2008/3229), Part 2 art. 3

²⁷² *Re Mumtaz Properties Ltd* [2011] EWCA Civ 610 at [30]; citing *Re Gemma Ltd* [2008] EWHC 546 (Ch); [2008] B.C.C. 812 at [40]

²⁷³ *Cook v Deeks* [1916] 1 A.C. 554 (PC), 563; see also, *Re Allied Business & Financial Consultants Ltd* [2009] EWCA Civ 751; [2009] B.C.C. 822 at [54]; S Beck, ‘The Saga of Peso Silver Mines: Corporate Opportunity Reconsidered’ (1971) 49(1) *Canadian Bar Review* 80, 89; cited Lindley, *Law on Partnership*, vol 1 (4th edn 1878)

and the formulation of purposes and objectives.²⁷⁴ Therefore this rejection of Rimer's LJ reasoning may have little practical difference for executives since the duty would still be very wide, most likely encompassing all opportunities, regardless of how they are received, because of the nature of the role undertaken by the executive director, which is to advance the open-ended interests of the company.

What is shown here is that the company constitution is open to any business. A partnership agreement and even extending circumstances were not, at least in *Aas*. It certainly is not for the director to decide what the company is or is not interested in and so it is wrong to draw an analogy with a partner's fiduciary duty. 'Since fiduciary obligations are not "one size fits all" it is, in my judgment, dangerous to reason by analogy.'²⁷⁵ A partner agrees to take responsibility for advancing the interests stipulated in the partnership agreement and any other interests evidenced beyond that making a scope of business test appropriate for partners because it identifies the limits of the partner's responsibility. A director's duty extends further because what they take responsibility for goes beyond the existing business of the company. A company can diversify and if a new opportunity is presented to a director that is outside the existing scope of business of the company, it cannot be left for the director to take the benefit without authorisation since, however improbable, the company may have been interested and the director generally will have undertaken responsibility to pursue it.

If a director is left to choose what the company is or is not interested in this would go against the rigid orthodox of fiduciary duties and the prophylactic concern of manipulating information by allowing the director the freedom to determine what is and what is not within the company's scope of business and to pursue new opportunities personally. Take, for example, a company in financial distress. If an opportunity is presented to a director that is

²⁷⁴ C Barnard, *The Functions of the Executive*, (Harvard University Press, 1964) 215

²⁷⁵ *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769 at [24]

outside the company's existing scope of business it cannot be left to the director to decide whether he or she could have the benefit if that opportunity could save the distressed company. If so, as Lord Loughborough LC argued, there would be great temptation to be negligent.²⁷⁶ This should show that Lim's and Kershaw's approval of the scope of business test runs in to certain difficulties in their reasoning. Certainly Lim's analogous reasoning with partners is difficult to reconcile with. As a result Rimer LJ was right to reject the scope of business test in this context but for the wrong reasons.

a. Role and function of the non-executive

The responsibility of a non-executive director is not equal to that of an executive. Whilst executive and non-executive are business terms. Both can be categorised as general fiduciaries who are granted access for the benefit of the company and the Companies Act 2006 does not differentiate them and the duties owed.²⁷⁷ However, their fiduciary duty is different because they do not undertake the same responsibility within the company. If Rimer's LJ analysis were to be applied equally to any director, non-executives would be stymied. They may take on a limited role within the company but have an unlimited fiduciary capacity, well beyond their responsibility. The common feature of additional appointments for non-executives would no longer be possible as each of their principals who are interested in any opportunity would conflict with one another even if the non-executive did not take responsibility to pursue the opportunity for each one.

Despite this justification for treating non-executives' fiduciary capacity as circumscribed by their limited role and function compared to an executive, the duty of loyalty must still function as an *ex post* form of control to prevent opportunistic behaviour by preferring one principal,

²⁷⁶ *Whichcote v Lawrence* (1798) 3 Ves 740, 752 (30 ER 1248)

²⁷⁷ See, Companies Act 2006, ss. 170, 250

or even themselves, over another. Therefore their role and function should be considered to determine the extent of their fiduciary duty.

The role of the non-executive has not remained static. It has developed and the exact nature has often been questioned. In 1945 the Cohen Report²⁷⁸ identified that there was no official body within a company responsible for supervision. Whilst there were mechanisms for control these were rarely of any use in practice. Different measures of control were suggested, such as supervisory boards, a public shareholder, increased powers to the Board of Trade and recourse to the courts, but it was generally agreed that 'too great an onus falls on the individual shareholder, who finds difficulties and expenses put in his way out of all proportion to the value of the results he could achieve'.²⁷⁹ The need for a monitoring body was supported by agency theory. Fama identified that boards of directors were market-induced mechanisms for a low-cost internal transfer of control.²⁸⁰ However, for that transfer to remain viable there should be independent non-executive directors to prevent against opportunism and self-serving behaviour. Although executive directors also engage in a fair amount of non-executive work, it is primarily the non-executives who will monitor the management. Thus, agency theory dictates that an effective board requires monitors to curb executive misfeasance. For that reason the primary role of the non-executive is one of monitoring to ensure executive directors do not use their own limited access to engage in self-serving behaviour.

However, non-executives are not mandatory and their role is not premised on any legislative material, therefore it is not a requirement that they actually monitor. Listing Rules do,

²⁷⁸ The Cohen Report, *The report of the committee on company law amendment*, (1945) Cmd 6659 (hereinafter Cohen Report)

²⁷⁹ M Rix, 'Company Law: 1844 and To-day' (1945) 55 *The Economic Journal* 242, 257

²⁸⁰ E Fama, 'Agency Problems and the Theory of the Firm' (1980) 88(2) *Journal of Political Economy* 288, 293

however, require companies to state how they comply with the UK Corporate Governance Code,²⁸¹ which states at least half the board should be independent non-executives²⁸² and the role they should undertake in the company.²⁸³ The role non-executives perform has been subject to similar reports, discussed below, which have sought to improve the role of non-executives in corporate governance. Empirical studies have also been conducted to establish the role that they fulfil,²⁸⁴ as well as some development by the judiciary.²⁸⁵ What has been observed is that non-executives have not always been prominent on boards nor has their role been limited to monitoring. This suggests a substantive change in their position on the board of directors and thus the role and function they undertake, potentially altering their fiduciary accountability.

Despite the Cohen Report being published in 1945, Aris identified that by 1972 non-executives were rare on company boards and were held by individuals with strong

²⁸¹ Financial Services Authority Listing Rules 9.8.6 para 6

²⁸² UK Corporate Governance Code B.1.2

²⁸³ UK Corporate Governance Code A.4

²⁸⁴ See Grant Thornton Corporate Governance Review, 'A Changing Landscape: Are you ready?' (2010) <http://www.grant-thornton.co.uk/thinking_blogs/publications/corporate_governance_review.aspx> accessed 14th Mar 2011; Grant Thornton Corporate Governance Review, 'Moving Beyond Compliance: Embracing the spirit of the code' (2009) <http://www.grant-thornton.co.uk/thinking_blogs/publications/corporate_governance_review_-2.aspx> accessed 14th Mar 2011; C Ingle and N van der Walt, 'Do Board Processes Influence Director and Board Performance' (2005) 13(5) *Corporate Governance: An International Review* 632; D Anderson, S Melanson and J Maly, 'The Evolution of Corporate Governance: power redistribution brings boards to life' (2007) 15(5) *Corporate Governance: An International Review* 780

²⁸⁵ See, for example, *Equitable Life Assurance Society v Bowley* [2003] EWHC 2263 (comm); [2003] B.C.C. 829 at [41]

connections to the company.²⁸⁶ Non-executives were often viewed with scepticism and a “job for the boys” that involved “rubber-stamping” executive decisions rather than monitoring.²⁸⁷ Therefore, non-executives were not substantially involved in the company with limited access to company property, information and affairs. The reasonable expectation from the company to loyalty would be minimal to those decisions they were “rubber-stamping”. It would not go beyond this even though the desired purpose of non-executives was foreseen as more actively involved in monitoring the management. Any role they did undertake would be evidenced by the facts of a specific case rather than a legislative statement or theoretical ideal of what they should have been doing. However, fiduciary liability would not be non-existent for a complicit non-executive director. A distinction can be drawn between those non-executives who rubber-stamped decisions and the director in *Pyke*. In *Pyke* the director had no involvement due to being forced out of the company whilst in a case of “rubber-stamping” decisions the director is complicit. In the former case, self-regard would not be objectionable because the director had no responsibility in respect of the opportunity the principal was interested in and so there was no risk his functions would not be performed properly. In the latter case the director is complicit but they still undertake the responsibility. In being complicit there would still be a risk that they will be motivated by personal gain in the performance of any “rubber-stamping” where there is a conflict.

Aris goes on to identify that by 1985 only 6% of companies lacked non-executive directors and in 20% of companies they were in the majority. It becomes of interest as to why companies after nearly 30 years of reluctance to appoint non-executives of sufficient calibre

²⁸⁶ S Aris, ‘Non-Executive Directors: Their changing role on UK boards’ (1986) *Economist Intelligence Unit* Special Report no 244, 4

²⁸⁷ S Aris, ‘Non-Executive Directors: Their changing role on UK boards’ (1986) *Economist Intelligence Unit* Special Report no 244, 6-8

had decided in a period of around ten years to appoint not only good quality non-executives, but appoint them in the majority.

It is interesting to observe that these changes in board structure came during the same period as other significant factors occurred to change the way companies operated. These notable changes included the demise of the *ultra vires* rule, the removal of trade barriers in Europe, which culminated in the single market in 1992, and the improvement in technology that helped facilitate business. All of these events facilitated business expansion. There were also significant corporate scandals²⁸⁸ that rejuvenated the calls for effective monitoring.

The *ultra vires* rule initially prevented companies from conducting business outside of its objects as set out in the company's constitution. For example, a company that sets out to make cars could not then begin to make ships. Whilst companies and lawyers found ways round the problems that the *ultra vires* rule caused, it still served as a restraint on business expansion and conduct. For example, lawyers attempted to draw up long lists of company objects, but the courts took the view that not everything a company did was capable of being an independent object and may only have been an ancillary power.²⁸⁹ In *Cotman v Brougham* it was identified that there was often confusion with power and purpose.²⁹⁰ This meant certain business activities were not capable of being pursued in their own right as a

²⁸⁸ See, for example, S Deakin and S Konzelmann, 'After Enron: An Age of Enlightenment?' 10(3) *Organization* 583; J Armour, S Deakin and S Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41(3) *British Journal of Industrial Relations* 531; S Prokesch, 'Ex-Guinness Head Guilty in Fraud' *New York Times* 28th Aug 1990 <<http://www.nytimes.com/1990/08/28/business/ex-guinness-head-guilty-in-fraud.html?pagewanted=all&src=pm>> accessed 17th July 2012

²⁸⁹ See, for example, *Re Horsely & Weight* [1982] Ch. 442, 448; *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch. 246, 288-9; *Re Introductions Ltd* (No. 1) [1970] Ch. 199; cf. *Johns v Balfour* (1889) 5 T.L.R. 389

²⁹⁰ *Cotman v Brougham* [1918] A.C. 514

separate object. Powers could not be used to pursue a different purpose and thus restricted what the company could do. Start-up companies may have also struggled where they may have been incapable of affording lawyers to draw up wide reaching objects clauses and thus expansion and survival may have been difficult.

The purpose behind the *ultra vires* rule was to protect the company by minimising the directors' discretion, but that protection prevented the directors from conducting activities that were potentially beneficial.²⁹¹ The company is now protected by fiduciary accountability, which gives broad discretionary power to act in the best interests of the company whilst remaining loyal. This broad discretion allowed for any company to move in to different markets. The removal of trade barriers facilitated this also as companies could then exploit opportunities across Europe.

As the increased opportunities presented themselves, companies needed effective ways to take advantage of them. As Sitkoff identifies, agents, or in this case directors, are appointed as the principal does not have the skills necessary to undertake the activity on their own.²⁹² As such, individuals were appointed who were familiar with the market or location a company was interested in moving in to. Whilst executives remained responsible for the day-to-day management they may have not had the expertise of moving in to different markets. The appointment of non-executives with knowledge of the market and existing networks helped fill that gap where specialised skill was needed. This was particularly useful for the company. As Eisenhardt and Schoonhoven identify that when a company is in difficult market conditions, such as a new market, the increase in networks and resources an

²⁹¹ R Sitkoff, 'The Economic Structure of Fiduciary Law' (2011) 91 B.U. L. Rev. 1039, 1042

²⁹² R Sitkoff, 'The Economic Structure of Fiduciary Law' (2011) 91 B.U. L. Rev. 1039

individual with a big network provides can aid survival and improve performance.²⁹³ Aris provides anecdotal evidences of such behaviour with the appointment of a prominent Japanese business man to the board of ICI as being attributed to giving the board more detailed insight to the important Japanese market.²⁹⁴

As a result, non-executives were not appointed to the board purely on the basis of monitoring executive management. Their role expanded to assisting in strategic development. This dual role was reflected in the Cadbury Report, published 1st December 1992, that sought to codify best practice of management of companies²⁹⁵ and pioneered the way for corporate governance codes across Europe and many of the recommendations are still part of the current UK Corporate Governance Code today. The Cadbury Report identified that the role of the non-executive was to review the performance of the board and executives²⁹⁶ and to take the lead in conflicts of interest.²⁹⁷ The overarching contribution appears to be one of monitoring and control, but the report identifies that this should not detract from the valuable contribution that can be made to leadership of the company.²⁹⁸

Since the Cadbury Report other reviews of corporate governance have taken place, which have sought to understand and define the role of the non-executive. Most of these reports have re-emphasised the need for non-executives to be effective monitors by dedicating more time to the company and becoming more involved to allow for active challenge to executive

²⁹³ K Eisenhardt and C Schoonhoven, 'Resource-Based View of Strategic Alliance Formation: Strategic and Social Effects in Entrepreneurial Firms' (1996) 7(2) *Organization Science* 136

²⁹⁴ S Aris, 'Non-Executive Directors' (1986) *Economist Intelligence Unit* Special Report no 244, 27

²⁹⁵ P Wickham and P Townsend, 'The non-executive director: A management perspective' (1994) 15(7) *Company Lawyer* 211

²⁹⁶ Cadbury Report para 4.5

²⁹⁷ Cadbury Report para 4.6

²⁹⁸ Cadbury Report para 4.10

decisions and assist in strategy. The Hampel Review acknowledged that non-executives were primarily appointed for their contribution to strategy and should have functions of monitoring and strategy.²⁹⁹ Despite these reviews it was opined that before the 2003 Higgs Review the role of the non-executive was still not understood.³⁰⁰ The Higgs Review sought to not only understand, but strengthen the role of the non-executive. Higgs highlights that expectations of non-executives had risen due to the complexity in business that have made it more difficult for individual shareholders to hold management to account.³⁰¹ Although it is of note that holding management to account has always been difficult as identified by the Cohen Report; rather expectations increased as their role developed and malpractice identified a distinct lack of control. This greater expectation to participate and control provides more evidence that the scope of a non-executive's fiduciary liability has increased.

In 2009 there has been further scrutiny of non-executives in response to the economic recession. The Walker Review has pushed for greater experience and knowledge of non-executives. The Review also continued the concern that the separation of responsibilities between executives and non-executives was not always understood.³⁰² The Walker Review was accepting of the functions of the non-executive that they go beyond just monitoring and control. The Review suggested that the definition in the Code should be redefined to emphasise constructive challenge in the boardroom.³⁰³

In broad terms, the role of the [non-executive director]... is: to ensure that there is an effective executive team in place; to participate actively in the decision-taking process of the

²⁹⁹ Hampel Report, (January, 1998) para 3.8

³⁰⁰ The Higgs Report, *Review of the role and effectiveness of non-executive directors*, (January, 2003) 3; J Roberts, T McNulty and P Stiles, 'Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom' (2005) 16 *British Journal of Management* 5

³⁰¹ The Higgs Report, *Review of the role and effectiveness of non-executive directors*, (January, 2003) para 1.6

³⁰² Walker Review (November, 2009) para 2.7

³⁰³ See UK Corporate Governance Code A.4

board; and to exercise appropriate oversight over execution of the agreed strategy by the executive team.³⁰⁴

One must concern themselves then that despite all the Reports, there is still a lack of understanding of non-executive functions and whether or not they are monitoring effectively. It must cast doubt over agency theory that appointing non-executives will ensure appropriate oversight. Yet the evidence is clear that the role and function of a non-executive and their fiduciary liability will have undoubtedly increased if they perform the role that is generally expected of them.

b. Consequences in practice

This role and function of monitoring and strategy can now be considered as to what it will mean in practice. Their role is beyond what Sinclair, Vogel and Snowden, as cited in *Cambridge v Makin*, considered the role of the non-executive to be: 'A non-executive director's role is usually limited to a supervisory one, effectively a policing function'.³⁰⁵ If the role is limited to a simple monitoring function then liability should only extend to what the company is doing. The non-executive's monitoring role, from an objective stand-point, is one where they are expected to understand and be aware of what the company is doing.³⁰⁶ This would most likely include past business and any new or proposed business. Moreover, if the role is restricted to only that of monitoring, their role, and thus the terms of their contract, would not imply pursuing business opportunities that are outside the scope of the company's current business. It is not reasonable to expect loyalty in regards to opportunities that fall outside the company's scope of business because the non-executive was not retained for

³⁰⁴ Walker Review (November, 2009) para 2.8

³⁰⁵ N Sinclair, D Vogel, R Snowden, *Company Directors: Law and Liability Vol 1* (Sweet & Maxwell, 1997) para 3.56; cited by *Cambridge v Makin* [2011] EWHC 12 (QB) at [48]

³⁰⁶ See, for example, *Lexi Holdings plc v Luqman* [2009] EWCA Civ 117; [2009] B.C.C. 716; *Equitable Life Assurance Society v Bowley* [2003] EWHC 2263 (comm); [2003] B.C.C. 829

that purpose. However, the consequences of allowing a non-executive to use their boardroom influence to compete with the company in areas of the company's existing business would be clear.³⁰⁷ Liability may be a grey area if, for example, a market diversifies. Thus, non-executives may be prevented from pursuing opportunities that are outside the existing company's scope of business to opportunities relating to where the market is diversifying or other specific situations.

The fact that the role extends to strategy advice will imply loyalty in a greater range of circumstances. Non-executives are no longer complicit in "rubber-stamping" the decisions of executive management but undertake an increasingly involved role within the company. Defining how far it extends for each circumstance would require 'a meticulous examination of the facts of each individual case'.³⁰⁸ A non-executive may have been appointed for particular expertise, such as for their knowledge of a particular market or sector. Therefore, as well as loyalty being reasonably expected in situations relating to the existing scope of the company's current business, it will extend to opportunities that the individual non-executive was appointed for similar to that seen in some of the employee fiduciary cases.³⁰⁹ Consequentially, as the role of the non-executive has expanded the logical conclusion is that the scope of loyalty has likewise expanded.

The consequence for multiple appointments is that a non-executive could not compete against their principal in respect of what it is actually doing because that is what they have responsibility for but their limited access does not mean they are liable for any interests of the company. Other fiduciaries may be able to compete against their own principal as Lord

³⁰⁷ See, *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [80]

³⁰⁸ *Cook v Elliot (No 2)* [1992] 1 NZLR 676, 685

³⁰⁹ *University of Nottingham v Fishel* [2000] I.C.R. 1462; *Ranson v Customer Systems plc* [2012] EWCA Civ 841; [2012] I.R.L.R. 769

Upjohn observed: 'It is perfectly clear that a solicitor can if he so desires act against his clients in any matter in which he has not been retained by them.'³¹⁰ This is because a fiduciary such as a solicitor may only undertake responsibility for specific interests but not all interests of the client whereas a non-executive will undertake responsibility for all those interests the company is involved in. Only if the director were to be specifically excluded or took on no role as in the cases of *Pyke, London and Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd*, and *Framlington plc v Anderson*,³¹¹ would the director be able to compete with the current interests of the principal.

Overall this means the fiduciary duty is a satisfactory way of ensuring that the non-executive acts for the benefit of the principal. Liability is strict and they will not be able to compete with the principal in respect of its current business, unless authorisation is given, as they are retained to monitor it. If they were allowed to compete there would be a risk of them not monitoring properly if they stood to gain personally. However, they are not retained to seek out new opportunities, unless the facts demonstrate otherwise. Therefore they are capable of pursuing opportunities for other principals, even though the first principal may theoretically have been interested in it due to the open-ended nature of the constitution, because they are not retained to pursue new business opportunities for the principal, and so there can be no reasonable expectation to loyalty in respect of those interests. A non-executive is strictly prevented from acting against the interests of their principal in respect of matters for which they are retained. Yet, this duty is becoming wider as greater emphasis is being placed on the role of the non-executive. Their role in strategy and advice increases the reasonable

³¹⁰ *Boardman v Phipps* [1967] 2 A.C. 46, 126; However, the position is perhaps not as simple as this cf. *Bolkiah v KPMG* [1999] 2 A.C. 222 – requiring a solicitor to satisfy the court that they will take all reasonable measure to ensure that no disclosure of confidential information would occur; *Marks & Spencer plc v Freshfields Bruckhaus Deringer* [2004] EWCA Civ 741; [2005] P.N.L.R. 4

³¹¹ *Framlington Group plc v Anderson* [1995] 1 B.C.L.C. 475

expectation to opportunities beyond the company's existing scope of business. This must cast doubt over Gower's observations as cited by Sedley LJ:

A reformed rule [would not] be inconsistent with the modern emphasis on a more important role for non-executive directors, who are often executive directors of other companies. Even if executive directors are regarded as a good source of non-executive talent for other companies (which some would question), a reformed rule would simply require executive directors not to become non-executive or *competing* companies, which they are, in fact, rarely asked to become.³¹²

The wide reaching responsibility of an executive and the increased responsibility of a non-executive may make holding multiple appointments more difficult as their role is more likely to compete with other positions. Given the discretion in the Companies Act 2006 as to whether it is reasonable to say there is a conflict of interest the courts may begin to find liability for non-executives where it should not exist, which may be possible if Rimer LJ *dicta* from *Re Allied Business* is followed, or even vice versa if the courts continue to perceive the role of the non-executive as simply one of monitoring as they did in *Cambridge*. If the former happens then non-executives may become deterred from sitting on more than one board. Given that the fees earned for a single non-executive role are small in comparison to the executives' remuneration, the inability to take on multiple roles may deter the best and most suitable people for the positions. If the latter approach were taken, fiduciary duties would not offer satisfactory protection to the company because the non-executive would be able to compete on matters they are retained for.

IV. A CASE OF THE EX: THE CONTINUING LIABILITY OF RESIGNED DIRECTORS

What has been established is that the current state of the law determines that where a director has a conflict between their interest and their responsibility, they will prefer their own

³¹² *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [83]; citing J Gower, *Principles of Modern Company Law*, (6th edn Sweet & Maxwell, 1997) 622

interests to the responsibility they undertook to act for their principal's benefit. Therefore the duty is strict and only looks to see whether the fiduciary failed to subordinate their interests to the principal's, due to the prophylactic concerns of opportunism, negligence and the ability to manipulate information inherent in such a relationship where an individual agrees to act for another's benefit.

With this strict liability directors may try to avoid their obligation to one principal by resigning from office to take an opportunity personally or divert the opportunity to another. Consequently it is logical that the duty continues after resignation. As Lord Eldon LC explained:

If the principle is right, that the solicitor cannot buy, it would lead to all the mischief of acting up to the point of the sale, getting all the information, that may be useful to him, then discharging himself from the character of solicitor, and buying the property. Infinite mischief would be the consequence in a number of cases.³¹³

This continuation has been codified in the 2006 Act.³¹⁴ The extension of the duty to post-resignation recognises that a director may try to "side-step" their obligation and strict liability by resigning from their post. Therefore its continuation seeks to prevent a director acting opportunistically when performing their functions and resign in an attempt to avoid liability and take an opportunity personally or present to another principal.

Yet the duty cannot continue forever. A director who has resigned cannot be continually held to loyalty to one principal. Such a rule would be anti-competitive in preventing a director to compete with their former principal, as well as restrictive in preventing the director to employ their services elsewhere. As Lord Goldsmith explained:

³¹³ *Re James* (1803) 32 E.R. 385, 391-2

³¹⁴ Companies Act 2006, s. 170(2)(a)

[The duty] indicates that that is subject to any necessary adaptations that the courts need to make in recognition of the fact that former directors are not in exactly the same position as current directors. These words signal to the courts that they may take into account the fact that the duties are being applied to former directors when interpreting and applying the duties. That means that the courts have more flexibility to take account of the fact that these are not current directors. If the amendment were to succeed, and the words were deleted, it might indicate that the duties were to apply to former directors in exactly the same way as they apply to current directors, which would not leave the flexibility that the courts need.³¹⁵

If the court has more flexibility then it does not continue in the same respect as it does for current directors. Applying the function of the duty to post-resignation liability against the relevant case law will aim to show how that control works and whether the duty is suitable in deterring non-executives from acting against the interests of the company after resignation.

A few attempts in the literature and from the judiciary have attempted to explain how the duty is to be applied post-resignation. The flexibility Lord Goldsmith spoke about has allowed those attempts to argue that liability is based on what is fair. For example, Lowry and Edmunds considered recent case law³¹⁶ to demonstrate “judicial enlightenment”³¹⁷ as they believed these cases to move away from the strict orthodox approach. Comments from the judiciary have also failed to acknowledge a clear approach to liability and this implied uncertainty is unhelpful when a clear pattern of liability seems to belie most of the decisions in this area. It was Rix LJ who said ‘the jurisprudence ... demonstrates ... where the critical line between a defendant being or not being a director becomes hard to police, the courts

³¹⁵ Hansard HL Vol 678, Official Report, 6/2/06 Col GC238-9

³¹⁶ *Island Export Finance Ltd v Umunna* [1986] B.C.L.C. 460; *Balston Ltd v Headline Filters Ltd* [1990] F.S.R. 385; *Framlington Group plc v Anderson* [1995] 1 B.C.L.C. 475; [1995] B.C.C. 611

³¹⁷ R Edmunds and J Lowry, ‘The no conflict-no profit rules and the corporate fiduciary: challenging the orthodoxy of absolutism’ (2000) *Journal of Business Law* 122,136

have adopted pragmatic solutions based on common-sense and merits based approach'.³¹⁸

It is considered here that those arguments are misguided and fail to conceive the nature of the duty and its purpose for continuing post-resignation. Ignoring the purpose of the duty and its function post-resignation and determining liability based on fairness 'could significantly expand, and possibly simultaneously attenuate the strict character of, fiduciary regulation'.³¹⁹ Through this analysis it will be shown when the duty will act as an *ex post* form of control in multiple appointments where directors attempt to "side-step" their obligations by resigning from one principal to pursue an opportunity with another and when a director can legitimately resign to compete with their former principal.

It is worth noting before analysing the duty that it is possible for companies to restrict what their directors can do post-resignation through restrictive employment covenants. Yet this does not mean the duty post-resignation should not be examined since such covenants may be narrower than the duty, especially for directors who have a very wide reaching duty. As well, despite restrictive covenants being available, cases on fiduciary duties post-resignation are still frequently heard demonstrating it is still a contentious area of law with practical effect.

a. Property, information or opportunities the director became aware of at a time he or she was a director

What has been established is that the duty needs something to be "hung from". It cannot change the terms of a contract validly entered in to. From this it was acknowledged that the duty only extends to matters the fiduciary took responsibility for. First and foremost, for liability to be established post-resignation the property, information or opportunity must be

³¹⁸ *Foster Bryant Surveying Ltd v Bryant* [2007] EWCA Civ 200; [2007] B.C.C. 804 at [76]

³¹⁹ R Flannigan, 'Access or Expectation: The test for fiduciary accountability' (2010) 89(1) *The Canadian Bar Review* 1, 10

something he became aware of at a time he was acting as a director. The rationale behind this is that the fiduciary is only loyal for what they take responsibility for. If they have resigned then there is no longer access and a reasonable expectation to loyalty on any new opportunities that are presented to the director after that time. The director has no longer undertaken responsibility to act for the benefit of the company on those particular matters and would be free to pursue the opportunity personally. It is unsurprising that no case law is present where liability has been established regarding an opportunity discovered post-resignation.

This criterion is implemented in to the wording of the Companies Act 2006, s. 170(2)(a) where it states that the opportunity must be something 'he became aware at a time when he was a director'. The use of the word "aware" acknowledges that a director will satisfy this requirement on the basis that he or she knows of the opportunity whilst acting for the principal. Therefore once the director discovers an opportunity whilst acting as a director it is possible the duty may be infringed post-resignation provided the remaining criteria are satisfied. The director cannot abstain from pursuing the opportunity since he would still be deemed "aware" of it. However, the wording does demonstrate that the director must be consciously aware and it does not seemingly extend to situations where they ought reasonably to be aware or opportunities that existed at the time of service that the director was not aware of at all. However, given that the duty is a general statement it may be possible for situations to develop where the director will satisfy the criterion where they ought reasonably to have been aware. This may be possible considering directors are usually deemed to know what is going on within the company.³²⁰

³²⁰ See, for example, *Lexi Holdings plc v Luqman* [2009] EWCA Civ 117; [2009] B.C.C. 716; *Equitable Life Assurance Society v Bowley* [2003] EWHC 2263 (comm); [2003] B.C.C. 829

b. Nature of responsibility

As well as the opportunity being made aware to the director during their service, that opportunity must also be one that was their responsibility to pursue. The duty needs something to be “hung from”. If there was no pre-existing responsibility to pursue the opportunity during the director’s service then there can be no liability for pursuing it post-resignation. If the duty’s continued existence is to prevent the “side-stepping” of responsibility to prefer one’s own interests, there must be some pre-existing responsibility to “side-step”. To have such a rule that established liability for opportunities that the director was not aware of or not their responsibility to pursue would make the duty more stringent post-resignation than for those directors currently serving, going against the purpose of making the duty more flexible. *Pyke* may be the best example of this for directors. Although in *Pyke* the director had not formally resigned, ‘had Mr Pyke formally resigned as a director ... his resignation would have done no more than reflect what had in practice already happened’.³²¹ Therefore his responsibility within the company was nominal. By pursuing the opportunity personally there was no conflict with his previous responsibility.

This means the opportunity pursued after resignation must be one that was their responsibility to pursue before resignation. Importantly the standard of liability remains the same and there does not necessarily have to be an act or omission by the director, as suggested by one commentator,³²² in relation to that opportunity whilst in office. Looking at the function of the duty it is designed to remove the prophylactic concerns in fiduciary relationships. Therefore strict liability is imposed and the court does not consider whether anything was or was not done. It simply looks to see whether there was a risk the director favoured their own interests ahead of their responsibility undertaken. If a director wishes to

³²¹ *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [94]

³²² P Koh, ‘Once a director always a fiduciary?’ (2003) 62(2) CLJ 403, 423

pursue an opportunity personally whilst in office that is his responsibility to pursue for the principal, there is a risk he or she may be negligent or opportunistic in the performance of his functions. Other factors such as good faith or whether the company could or would take the opportunity will be dismissed as irrelevancies because loyalty simply requires you to treat your own interests as subservient. The prophylactic concerns of the risk of disloyalty remain and are observed in the following judgment:

Such a bold submission cannot be right, amounting as it does to the contention that a director, provided he does nothing contrary to his employers' interests while employed, may with impunity conceive the idea of resigning so that he may exploit some opportunity of the employers and, having resigned, proceed to exploit it for himself.³²³

c. Prompted or influenced to resign

Because the concerns remain the arguments put forward by other commentators that there must be a maturing business opportunity, or the courts will look to achieve a fair result based on whether the principal could or would take the opportunity are not sustainable.³²⁴ They do not consider the function of the duty of removing the prophylactic concerns in situations the director took responsibility for. Their duty is one of loyalty. If it is the director's responsibility to pursue the opportunity before resignation then they cannot conceive the idea of exploiting it personally by resigning because there is a risk they will not have treated their interests as subservient to their responsibility.

If strict liability remains post-resignation for opportunities that the director had the responsibility to pursue during their tenure this is yet to show the flexibility available to the courts. The analysis would fail to explain how liability has been avoided by directors in

³²³ *Island Export Finance Ltd v Umunna* [1986] B.C.L.C. 460, 480

³²⁴ See, for example, R Edmunds and J Lowry, 'The no conflict-no profit rules and the corporate fiduciary: challenging the orthodoxy of absolutism' (2000) *Journal of Business Law* 122

several cases concerning an opportunity that was their responsibility to pursue before resignation that they were aware of during their tenure.

The wording from *Umunna*, that a director must “conceive the idea” of exploiting the opportunity by resigning, relates to the third characteristic that demonstrates the flexibility available to the court concerning resigned directors that Lord Goldsmith spoke of. This third criterion is that the director must be prompted or influenced³²⁵ to resign by that opportunity. If they are not prompted or influenced by the opportunity then there is no disloyalty. As Rix LJ contended, liability can be avoided where the pursuit was not accompanied by disloyalty.³²⁶ A director will be liable where he ‘resigns his office to take advantage of a business opportunity of which he has knowledge as a result of his having been a director’.³²⁷

As such the duty of loyalty does not survive resignation. It only remains attached to opportunities the director had responsibility to pursue before resignation. If a causal link is established between the pursuit of the opportunity and resignation i.e. they were prompted or influenced by the opportunity to resign then liability will attach. This approach can be seen in *Foster Bryant*:

In my judgment, Lawrence Collins J was not saying that the fiduciary duty survived the end of the relationship as director, but that the lack of good faith with which the future exploitation was planned while still a director, and the resignation which was part of that dishonest plan, meant that there was already then a breach of fiduciary duty, which resulted in the liability to account for the profits which, albeit subsequently, but causally connected with that earlier

³²⁵ See, for example, *Foster Bryant Surveying Ltd v Bryant* [2007] EWCA Civ 200; [2007] B.C.C. 804 at [40], [66]; *Thermascan Ltd v Norman* [2009] EWHC 3694 (Ch); [2011] B.C.C. 535 at [14]; *CMS Dolphin Ltd v Simonet* [2001] 2 B.C.L.C. 74 at [92]

³²⁶ *Foster Bryant Surveying Ltd v Bryant* [2007] EWCA Civ 200; [2007] B.C.C. 804 at [77]

³²⁷ *CMS Dolphin Ltd v Simonet* [2001] 2 B.C.L.C. 74 at [87]

fiduciary breach, were obtained from the diversion of the company's business property to the defendant's new enterprise.³²⁸

The three requirements that a director had the responsibility to pursue the opportunity that he was aware of and was prompted or influenced to resign to take it personally have been recognised explicitly in two commonly cited cases. First, in the Canadian authority of *Canadian Aerospace Services Ltd v O'Malley (CANAERO)*:

An examination of the case law ... shows the pervasiveness of a strict ethic in this area of the law ... this ethic disqualifies a director or senior officer from usurping for himself or diverting to another person or company with whom or with which he is associated a maturing business opportunity which the company is actively pursuing; he is also precluded from so acting even after his resignation where the resignation may fairly be said to have been prompted or influenced by a wish to acquire for himself the opportunity sought by the company, or where it was his position with the company rather than a fresh initiative that led him to the opportunity which he later acquired.³²⁹

The case demonstrates that even after resignation the strict ethic is rigorously pursued. The second case to demonstrate the criteria clarifies the wording of *CANAERO* by replacing “or” with “and” to demonstrate that both characteristics need to be present. Hutchinson J explained the necessary clarification:

It would, it seems to me, be surprising to find that directors alone, because of the fiduciary nature of their relationship with the company, were restrained from exploiting after they had ceased to be such any opportunity of which they had acquired knowledge while directors. Directors, no less than employees, acquire a general fund of knowledge and expertise in the course of their work, and it is plainly in the public interest that they should be free to exploit it in a new position.³³⁰

³²⁸ *Foster Bryant Surveying Ltd v Bryant* [2007] EWCA Civ 200; [2007] B.C.C. 804 at [69]; referring to *CMS Dolphin Ltd v Simonet* [2001] 2 B.C.L.C. 74 per Lawrence Collins J

³²⁹ *Canadian Aerospace Services Ltd v O'Malley* (1973) 40 DLR (2d) 371

³³⁰ *Island Export Finance Ltd v Umunna* [1986] B.C.L.C. 460, 482

Hutchinson J clarifies that opportunities discovered during the tenure of the director's service cannot be an independent criterion for establishing liability. This was later endorsed in *CMS Dolphin Ltd v Simonet*.³³¹ It must be coupled with the disloyal element of being prompted or influenced by the opportunity for otherwise it would go against the public interest. That public interest refers to the anti-competitive nature such a rule would have because it would prevent the director competing with their former principal simply because he was aware of the opportunity that was his responsibility to pursue during his tenure. As well it would unreasonably restrict the ability of the director to employ his services elsewhere. This is because the director would not be able to exploit opportunities they were previously aware of but not necessarily prompted or influenced to resign because of them.

Hutchinson's J clarification shows that the requirement that the director is prompted or influenced is needed because where it is not present the prophylactic concerns of the duty are removed. If the director is not prompted or influenced to resign by the opportunity there can be said to be no risk that he or she would have been negligent or opportunistic in the performance of his or her functions. There may always be a risk that a director resigns to pursue an opportunity personally and continually pursuing the strict ethic post resignation has its merits; but this needs to be balanced against the interests of the individual who may wish to deploy their services elsewhere, continue their own business in competition or otherwise separate from their previous employer. Therefore the courts need to assess whether the director has been prompted or influenced.

What is meant by prompted or influenced is not something the courts have elaborated on. The wording demonstrates a subjective test for assessing the director's state-of-mind for resignation. Taking its literal meaning it would mean that the desire to pursue the opportunity personally needs to be only a reason to consider resigning (prompted) or a reason the

³³¹ *CMS Dolphin Ltd v Simonet* [2001] 2 B.C.L.C. 74 at [92]

director uses to decide to resign (influence). It does not have to be the primary reason. Therefore the flexibility available to the court is quite narrow. It would seem the courts are still concerned with the ability of the fiduciary to manipulate the information in the court to make it appear it may have not been the primary reason for resignation. The fact they considered the opportunity as a reason for resigning is enough for the court to determine there was a risk of disloyalty and impose liability.

To establish whether the director was prompted or influenced requires the courts to look at the facts to determine the director's state-of-mind for resigning. This factual assessment is what other commentators³³² and judges³³³ have used as evidence to support the notion that the courts are determining liability on what is fair. This is not the case. The courts at this point are not attempting to determine whether or not the company was interested or whether the director has undertaken the responsibility to pursue the opportunity because the strict ethic is still maintained to prevent directors "side-stepping" the duty; but they are seeking to establish whether the director's decision to retire was in some way based on disloyalty. As Sedley LJ noted it was irrelevant that the client made it clear they no longer wished to work with the client.³³⁴ The relevant point was that his desire to pursue the opportunity came after his effective resignation at a point in time when his fiduciary obligation was nominal³³⁵ and could not be said to have been prompted or influenced to resign by the opportunity breaking the causal link between opportunity and resignation. Yet it is by no means an easy assessment to establish the director's state-of-mind for their resignation. As Rix LJ explained that whilst cases such as *Pyke* may be clear that the director was not prompted or influenced

³³² See, for example, R Edmunds and J Lowry, 'The no conflict-no profit rules and the corporate fiduciary: challenging the orthodoxy of absolutism' (2000) *Journal of Business Law* 122; E Lim, 'Directors' fiduciary duties – A new analytical framework' (2013) 129 LQR 242

³³³ See, for example, *CMS Dolphin Ltd v Simonet* [2001] 2 B.C.L.C. 74 at [92]

³³⁴ *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [86]

³³⁵ *Plus Group Ltd v Pyke* [2002] EWCA Civ 370; [2003] B.C.C. 332 at [90]

to resign by the opportunity and in other cases such as *Industrial Developments Consultants Ltd v Cooley*³³⁶ where it was clear the director had been prompted or influenced, due to the director lying about the state of their health so as to be discharged from their contract, 'in the middle are more nuanced cases which go both ways'.³³⁷

However, this nuance becomes easier when put in to the context of the function of the duty. If it can be proved that the director conceives the idea before resigning then there is a risk they would have preferred their own interests and not been loyal. In this situation there is a responsibility for the director to pursue the opportunity for the principal at the time the idea was conceived to pursue it personally and so there is something for the duty to be "hung from". They cannot "side-step" that duty where it has attached to a responsibility by resigning. This was the case in *Cooley*, where the director conceived the idea before resignation when the opportunity was presented to him personally and then misrepresented his health to be discharged from his contract so as to pursue it.³³⁸ However, where the resignation is not prompted or influenced by the opportunity there is nothing for the duty to be "hung from" because the causal link between the two events is broken. The general body of case law therefore seems to acknowledge that if it is established that the idea is conceived after resignation then there is no breach because they cannot be said to be prompted or influenced to resign by it. However, where it is conceived before resignation there is a risk they may be negligent or opportunistic.

*Balston Ltd v Headline Filters Ltd*³³⁹ is an example of the need for there to be a causal link established by determining whether the director was prompted or influenced by the

³³⁶ *Industrial Developments Consultants Ltd v Cooley* [1972] 1 W.L.R. 443

³³⁷ *Foster Bryant Surveying Ltd v Bryant* [2007] EWCA Civ 200; [2007] B.C.C. 804 at [77]

³³⁸ *Industrial Developments Consultants Ltd v Cooley* [1972] 1 W.L.R. 443, 452-3

³³⁹ *Balston Ltd v Headline Filters Ltd* [1990] F.S.R. 385

opportunity. Here a company had decided to stop supplying filter tubes to a client. The director at the time had decided to resign and compete with the company but at the time of resignation did not know what the competition would be. Provided the director does not take more than preparatory steps there is no rule preventing a director considering competing with the former principal.³⁴⁰ It was not until after the resignation that the client made contact with the director about supplying filter tubes. His resignation though was clearly evidenced as being based on a desire to compete but not take or divert any specific opportunity. Facts such as the opportunity being presented to the director after resignation and the company not pursuing it helped evidence he was not prompted or influenced. As with *Pyke*, the fact the company was no longer pursuing the contract did not serve to demonstrate the company was not interested in the opportunity. If the director had resigned to take it personally it would not have mattered if the company had not been pursuing it at the time because the director had the responsibility to do it for the company and that responsibility was regulated by the duty of loyalty which is strict. Since he conceived the idea of pursuing the opportunity after resignation meant there was no causal link between resignation and the pursuit of the opportunity and thus no disloyalty. The fact the company was no longer pursuing the contract helped the court determine the director's state-of-mind, but it would not have been conclusive on its own.

As well as *Pyke* and *Balston*, a third case of relevance is *Foster Bryant*. The judge here expressly recognised that the courts conduct a “merit based” assessment as to whether the director was prompted or influenced and whether they have been disloyal.³⁴¹ Here the opportunity was only presented to the director personally after resignation. Also, his resignation was evidenced on him being effectively removed from office when the majority

³⁴⁰ See, for example, *Berryland Books Ltd v BK Boots Ltd* [2009] EWHC 1877; [2009] 2 B.C.L.C. 709 (ch); *British Midland Tool Ltd v Midland International Tooling Ltd* [2003] EWHC 466 (Ch); [2003] 2 B.C.L.C. 523

³⁴¹ *Foster Bryant Surveying Ltd v Bryant* [2007] EWCA Civ 200; [2007] B.C.C. 804 at [77]

shareholder and only other director made his wife redundant. The client who previously had the contract with the company offered a solution of splitting the contract between the two directors. The majority shareholder and remaining director refused whilst the resigned director took the opportunity. The fact there was no secret behind the director's pursuit of the opportunity was supportive evidence that he had not been disloyal.³⁴² However, it was vital for avoiding liability that the opportunity was only presented to the director personally after resignation. If the opportunity had been presented personally to the director before resignation there would have been greater difficulty in demonstrating the resignation was not in some way prompted or influenced by the opportunity regardless of his wife's redundancy. This is because there would be a risk the resignation was based on disloyalty.

These three cases demonstrate that where the opportunity is presented to the director again after resignation serves as strong evidence that they were not prompted or influenced to resign by the prospect of taking the opportunity. However, other cases such as *Cooley*, *CANAERO*, and *CMS Dolphin* have all established liability post-resignation where the opportunity was presented to them before resignation. Contrasting *Cooley* with *Foster Bryant* and *Balston*, in all three situations whilst the company could or would not take the opportunity this was irrelevant. The pivotal point however, was that in the latter two cases they had not been prompted or influenced as evidenced by the fact they conceived the idea post-resignation and were no longer under an obligation to pursue it for the former principal; but in *Cooley* whilst the company could not take the opportunity, the director conceived the idea to take it personally whilst still in office and his desire to take it personally was evidenced by the misrepresentation as to his health. Therefore the courts having established the director was prompted or influenced to resign by the opportunity will maintain the strict ethic of liability and only seek to establish whether there was a risk of the director preferring their own interests to their responsibility. All other facts are irrelevant in this assessment and

³⁴² *Foster Bryant Surveying Ltd v Bryant* [2007] EWCA Civ 200; [2007] B.C.C. 804 at [4]

the only thing to alleviate the director would be authorisation. This means it becomes substantially more difficult to demonstrate you were not prompted or influenced by the opportunity to resign where it is presented to the individual prior to resignation. This is perhaps a continued recognition of the strict approach the courts have taken to conflicts. If a director is presented with an opportunity personally before resignation then there is a risk that resignation may have been prompted or influenced by the opportunity meaning there was a risk they were negligent in the performance of their functions.

Despite this, is not impossible to avoid liability where it is presented to the director before resignation. Specific facts, such as those in *Framlington Group plc v Anderson*, may help prevent liability being established. In this case the company barred its two directors from the negotiation of the sale of some of its assets because the purchaser also wished to acquire the directors' services to manage the assets. Therefore whilst they were presented with the opportunity prior to resignation, their resignation was not prompted or influenced by the opportunity because it was dependent on the company accepting an offer with which they had nothing to do.

The function of the duty therefore explains liability for directors who have resigned. If the function is to remove prophylactic concerns by imposing strict liability then this must be maintained whether they are a current or resigned director. Considerations of whether the company could or would have the opportunity are irrelevant. If these factors are relevant to whether the company is interested and whether the director had the responsibility to pursue it, those commentators who support this have failed to explain how the courts could so radically depart from the strict orthodox without a clear justification. The logical conclusion must be that they did not. What is relevant is whether the prophylactic concerns remain after resignation when the opportunity is pursued. If the director can show they conceived the idea of pursuing the opportunity after resignation then there are no prophylactic concerns

because the director is no longer in a position to manipulate the information or be opportunistic in the performance of his responsibility when he decides to pursue the opportunity. Where the idea is conceived prior to resignation the risk arises that the director may have been opportunistic. Whether the opportunity was maturing or not does not matter because the strict approach simply requires other interests to be subservient to the principal's interests. The director's responsibility is to pursue the opportunity for the principal. They cannot conceive the idea of resigning to take it personally because there is a risk they may not try their hardest to pursue it for the principal and so strict liability must be maintained.

It is theoretically possible then that a fiduciary duty to one principal may last forever. There can be no cut off point, which was suggested by Koh to be one year.³⁴³ If a director, whilst in office, conceives the idea of resigning to take an opportunity they could not avoid liability simply because there has been a lapse of time. This is because whilst in office there was a risk that they preferred their own interests to their responsibility. In practice this never-ending loyalty would not cause too much difficulty since an opportunity is unlikely to be around forever and in most cases the director seeks to pursue the opportunity fairly soon after resignation.³⁴⁴

The consequences for non-executive directors concerning new appointments that compete with their former principal is that the desire to do so must not be prompted or influenced by an existing opportunity that the director has the responsibility to pursue. However, the duty still operates on a strict basis once it is demonstrated that they were prompted or influenced to resign by the opportunity because there is a risk that they may not be loyal when performing their functions. The duty as an *ex post* form of a control post-resignation is still

³⁴³ P Koh, 'Once a director always a fiduciary?' (2003) 62(2) CLJ 403, 427

³⁴⁴ see, for example, *Industrial Developments Consultants Ltd v Cooley* [1972] 1 W.L.R. 443, 452-3

effective in preventing non-executive directors acting opportunistically. If they owe obligations to two principals they will be prevented from resigning from one to “side-step” their obligation to that principal and divert the opportunity to another.³⁴⁵

V. CONCLUDING REMARKS

The standard and scope of a fiduciary’s duty demonstrates that its ability to vary depending on the responsibility undertaken deters any opportunistic diversion from non-executive directors on matters retained for. Therefore their decisions when serving for one company cannot be influenced by any personal interest in another company. If a principal retains them for a certain matter, they cannot divert related opportunities to another principal. This means it can be an effective *ex post* form of control in ensuring the non-executive acts for the benefit of the company if the company enforces them. However, it is recognised that whether fiduciary duties themselves have an effect on the behaviour of non-executive directors would require further empirical study. Their increased role and access within the company does not allow them to act against their principal with impunity. If the companies that the non-executives serve for are not in direct competition this will be of little problem given the responsibility a non-executive undertakes. However, the increased role of the non-executive may be reducing the amount of positions they can take because their responsibility to one principal is greater. Also, the confusion of their role and a failure of the courts and commentators to appreciate the scope of the duty being based on the responsibility undertaken and not what the company does may mean that the ability to take multiple appointments is reduced still further. This failure to recognise the different roles directors can undertake in the company may mean non-executives are not treated any differently from executives despite having different responsibility. Yet without clear justification to the contrary directors, like other fiduciaries, should not have to be loyal for matters not retained, as there can be no reasonable expectation from the principal that they are. Therefore their

³⁴⁵ *Re James* (1803) 32 E.R. 385

duty is circumscribed at that point. The confusion in the Court of Appeal that directors have unlimited fiduciary capacity seems to be based on the fact executive directors take on a very wide responsibility since the company, unlike a solicitor's client, is an artificial entity and therefore they undertake to act in its interests generally. Whilst this may have little practical difference then for executive directors, an interpretation that director liability is based on what the principal does rather than what the individual takes responsibility for may severely limit the opportunities the non-executive can pursue outside of their obligation to that one principal. The ultimate end of the Court of Appeal's analysis may be that the fiduciary duty of loyalty for non-executives goes disproportionately beyond *ex post* control in ensuring they act for the benefit of the company to the point of oppressive loyalty and the fiduciary jurisdiction will deter those willing and capable from serving on multiple boards. The company law reform has missed the opportunity to resolve fiduciary jurisdiction for directors. However, a correct interpretation of the duty's scope shows that the duty in theory should restrict self-interest amongst non-executives sufficiently.

The discussion evidenced that the duty still applies to an extent after resignation and the limited flexibility available to the courts in recognising that the director who has resigned is not in the same position as a current director means that the duty is still effective in preventing opportunistic diversion on matters retained for. Directors cannot conceive the idea of resigning to divert an opportunity. This is because there is a risk they will be negligent when performing their functions in regard to that opportunity. When the duty is considered in the context of its function of removing the prophylactic concerns it becomes clear that the duty remains strict once it is shown the director was prompted or influenced to resign by the opportunity. The concern here is that the courts and commentators have often confused this flexibility in determining whether the director was prompted or influenced with a freedom to decide what is fair as to whether the company is interested. Such an approach goes against the prophylactic concerns and would allow the director to act opportunistically

in diverting opportunities that the company could not or would not take regardless of the fact they are retained to pursue those opportunities for that principal and be loyal when doing so. If the duty is relaxed in such a way as to what is fair a director may be able to manipulate the information to make it appear that the company was not interested and divert opportunities to themselves or another principal. This would be unsatisfactory in preventing self-interest amongst non-executives and cannot be viewed as correct.

It is perhaps a worry that the legislators failed to incorporate Hutchinson's J clarification of *CANAERO* in the 2006 Act that the director needs to be prompted or influenced as well as being aware of the opportunity whilst in office that he had a duty to pursue. The section only provides for the first part that the duty continues in respect of opportunities he became "aware of at a time when he was a director". It continues that the duty will be subject to "any necessary adaptations". This wording is fairly ambiguous and is perhaps the result of the courts failing to clearly state why the duty continues post resignation. This wording leaves the option available for courts to continue to apply fiduciary liability on the basis of what is fair for directors who have resigned, which, for reasons observed, should not be permitted.

Non-executives who do have multiple appointments should be diligent in regularly assessing what their responsibility is within each role to ensure the roles do not overlap. With their increased role they will need to be more mindful when acting for multiple principals and should remember that if there is any doubt they can always seek authorisation to defend and claim for breach of duty.

Chapter IV

Enforcing a non-executive's fiduciary duty: The statutory derivative claim as ex post control

'...in the business world it was known that the imposition of penalties did not stop in any great degree persons who were determined to make their fortune by robbing their neighbours of their earnings, whereas it would keep out honourable men who were afraid of finding themselves committing an error without knowing it.'³⁴⁶

I. DERIVATIVE CLAIMS AS A MECHANISM FOR ENFORCEMENT

Viable enforcement of fiduciary duties is important to ensure self-interest is deterred. Theoretically, a legal deterrent can motivate directors for fear of adverse financial consequences,³⁴⁷ but the lack of one can foster fraud, scandals and bad corporate governance ultimately harming investor confidence.³⁴⁸ The new statutory derivative claim, which replaced the common law claim³⁴⁹ that allows shareholders to litigate in the name of the company has since its introduction in 2006,³⁵⁰ heard 14 claims,³⁵¹ 12 of which have

³⁴⁶ Sir Albert Rollit, Hansard HC Vol 84, Official Report 26/6/1900 Col 1156

³⁴⁷ B Cheffins and B Black, 'Outside Director Liability Across Countries' (2006) 84 *Texas Law Review* 1385, 1387

³⁴⁸ Z Zhang 'Legal Deterrence: the foundation of corporate governance – evidence from China' (2007) 15(5) *Corporate Governance: An International Review* 741

³⁴⁹ See, *Foss v Harbottle* (1843) 2 Hare 461; *Edwards v Halliwell* [1950] 2 All E.R. 1064; Law Commission, Shareholder Remedies (Law Com No 246) (Cm 3769, 1997) (hereinafter Law Commission Report), para 6.55

³⁵⁰ Companies Act 2006, Part 11

³⁵¹ *Bamford v Harvey* [2012] EWHC 2858 (Ch); [2013] Bus. L.R. 589; *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch); *Fanmailuk.com Ltd v Cooper* [2008] EWHC 2198 (Ch); [2008] B.C.C. 877; *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885; *Hughes v Weiss* [2012] EWHC 2363 (Ch); *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420; *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) L.S.G. 19; *Kiani v Cooper* [2010] EWHC 577 (Ch); [2010] B.C.C. 463; *Mission Capital Plc v Sinclair* [2008] EWHC 1339 (Ch); [2008] B.C.C. 866; *Parry v Bartlett* [2011] EWHC 3146 (Ch); *Phillips v Fryer* [2012] EWHC 1611 (Ch); [2013] B.C.C. 176; *Re Seven Holdings Ltd* [2011] EWHC 1893 (Ch); *Stainer v Lee*

concerned fiduciary duties³⁵² suggesting a suitable means of enforcement against non-executive directors.

Traditionally, enforcement of duties has been particularly difficult with low levels of litigation as there were effectively zero claims filed against directors of public listed firms between 2004-2006³⁵³ and only 2% of directors, in a 1999 study by Deakin and Hughes, reporting their firm to have commenced litigation against one of its directors for breach of duty.³⁵⁴ Cheffins and Black have also specifically highlighted the unlikelihood that a company would litigate against its non-executive directors³⁵⁵ as has the Higgs Report.³⁵⁶ There may be several reasons why enforcement by the company is low. The company is the proper claimant.³⁵⁷ It is the only one who can enforce its rights, at the behest of the board of

[2010] EWHC 1539 (Ch); [2011] B.C.C. 134; *Stimpson v Southern Landlords Association* [2009] EWHC 2072 (Ch); [2010] B.C.C. 387

³⁵² The two that did not were *Bamford v Harvey* [2012] EWHC 2858 (Ch); [2013] Bus. L.R. 589; *Re Seven Holdings Ltd* [2011] EWHC 1893 (Ch)

³⁵³ J Armour *et al*, 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and United States' (2009) 6(4) *Journal of Empirical Legal Studies* 687, 699-700

³⁵⁴ S Deakin and A Hughes, *ESRC Report* (ESRC Centre for Business Research, University of Cambridge 1999) para 5.2

³⁵⁵ B Cheffins and B Black, 'Outside Director Liability Across Countries' (2006) 84 *Texas Law Review* 1385; see also, H Hirt, 'The review of the role and effectiveness of non-executive directors: a critical assessment with particular reference to the German two-tier board system: Part 2' (2003) 14(8) *International Company and Commercial Law Review* 261, 266-7

³⁵⁶ The Higgs Report, *Review of the role and effectiveness of non-executive directors*, (January, 2003) para 14; H Hirt, 'The review of the role and effectiveness of non-executive directors: a critical assessment with particular reference to the German two-tier board system: Part 2' (2003) 14(8) *International Company and Commercial Law Review* 261, 267

³⁵⁷ *Foss v Harbottle* (1843) 2 Hare 461 – The rule here was that where a wrong done to a company the proper plaintiff is prima facie the company and where the alleged wrong may be ratified by a simple majority no individual member could bring a claim in respect of it

directors³⁵⁸ or special resolution of the shareholders.³⁵⁹ These individuals may not commence litigation for several reasons. For example, if the wrongdoers are those in control they are unlikely to commence litigation against themselves.³⁶⁰ Directors may be unwilling to litigate against one of their own in an effort to maintain a collegiate atmosphere,³⁶¹ have incentives not to reveal any maladministration for fear of being liable themselves or simply do not view litigation to be in the best interests of the company.³⁶² Director removal via an ordinary resolution³⁶³ may also not be a sufficient deterrent for similar reasons.³⁶⁴ As well, if the benefit to the director from acting with self-interest out-weighs the loss of removal it would be unlikely to deter the director.³⁶⁵ Whilst collectively shareholders may commence litigation they too may have reasons not to, such as apathy and difficulties in detecting breaches due to information asymmetries.³⁶⁶ The unfair prejudice remedy³⁶⁷ is capable of

³⁵⁸ Subject to the company's constitution

³⁵⁹ P Davies and S Worthington, *Gower and Davies: Principles of Modern Company law* (9th edn Thomson/Sweet & Maxwell, 2012) 645-6

³⁶⁰ *Wallersteiner v Moir* (No 2) [1975] Q.B. 373, 390

³⁶¹ See, for example, L Bebchuk and J Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, (Harvard University Press, 2006); B Cheffins and B Black, 'Outside Director Liability Across Countries' (2006) 84 *Texas Law Review* 1385, 1404

³⁶² See, B Cheffins and B Black, 'Outside Director Liability Across Countries' (2006) 84 *Texas Law Review* 1385, 1466; *Equitable Life Assurance Society v Bowley* [2003] EWHC 2263 (Comm); [2003] B.C.C. 829; T Thorniely, 'Ex-directors hit back at Equitable' *The Telegraph* (London, 25 Sep 2003) <<http://www.telegraph.co.uk/finance/2864091/Ex-directors-hit-back-at-Equitable.html>> accessed 21st August 2013

³⁶³ Companies Act 2006, s. 168

³⁶⁴ See, C Jungmann, 'The Effectiveness of Corporate Governance in One-Tier and Two-Tier Board Systems' (2006) ECFR 426

³⁶⁵ See, Z Zhang 'Legal Deterrence: the foundation of corporate governance – evidence from China' (2007) 15(5) *Corporate Governance: An International Review* 741

³⁶⁶ See, for example, S Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119(6) *Harv. Law Rev.* 1735

remedying fiduciary duties³⁶⁸ for shareholders but only for the individual shareholder bringing a claim who has suffered unfair prejudice.³⁶⁹ Since this thesis is looking at aligning the interests with the company, how unfair prejudice remedies fiduciary breaches will not be discussed.

However, in exceptional circumstances an individual or group of shareholder(s) may litigate in the name of the company, subject to standing restrictions, to enforce its rights rather than the shareholders' personal rights. This exceptional circumstance is the derivative action and Lord Denning articulated the reasoning behind it:

It is a fundamental principle of our law that a company is a legal person, with its own corporate identity, separate and distinct from the directors or shareholders, and with its own property rights and interests to which it alone it is entitled. If it is defrauded by a wrongdoer, the company itself is the one person to sue for the damage. Such is the rule in *Foss v Harbottle* (1843) 2 Hare 461. The rule is easy enough to apply when the company is defrauded by outsiders. The company itself is the only person who can sue... but suppose it is defrauded by insiders who control its affairs – by directors who hold the majority of the shares – who then can sue for damages? Those directors are themselves the wrongdoers. If a board meeting is held, they will not authorise the proceedings to be taken by the company against themselves...yet the company is the one person who is damnified. It is the one person who should sue. In one way or another some means must be found for the company to sue. Otherwise the law would fail in its purpose. Injustice would be done without redress.³⁷⁰

³⁶⁷ Companies Act 2006, Part 30

³⁶⁸ *Re Elgindata* [1991] B.C.L.C. 959; *Re Charnley Davies Ltd (No 2)* [1990] B.C.L.C. 760; *Kung v Kou* (2004) 7 HKCFAR 579; *Clark v Cutland* [2004] 1 W.L.R. 783; *Gamlestaden Fastigheter AB v Baltic Partners Ltd* [2007] UKPC 26; [2007] Bus. L.R. 1521 (PC (Jer))

³⁶⁹ See, B Cheffins and B Black, 'Outside Director Liability Across Countries' (2006) 84 *Texas Law Review* 1385, 1409

³⁷⁰ *Wallersteiner v Moir (No 2)* [1975] Q.B. 373, 390

To bring a derivative action in the name of the company the court must first grant permission, previously under the common law and now under the statutory procedure in Part 11 of the 2006 Act, because of the principles from *Foss v Harbottle* that the company is the proper claimant and if the wrong can be ratified by a simple majority no individual shareholder can bring a claim. The fact that a wrong is done to the company does not immediately give rise to an action by a shareholder otherwise the court would be presented with any number of actions from individual shareholders trying to enforce the company's rights that could be highly frivolous in nature. Therefore a shareholder must initially bring a derivative claim to establish standing. Standing was, and still is, restricted to only certain types of unlawful activity. However, both pre and post 2006 exceptions have included a breach of fiduciary duty by a director,³⁷¹ although pre-2006 only covered such a breach where there was fraud on the minority.³⁷² The fact that 12 claims from 14 since 2006 have concerned a breach of fiduciary duty under section 175, and one of those cases has concerned non-executive directors,³⁷³ may mean that the new procedure can be effective in deterring non-executives from breaching their fiduciary duty and is worth analysing. This will be done by looking at the 14 claims brought under the new statutory procedure. Since the cases themselves do not focus on whether there has been a breach, as the claim is only to establish standing and is not a full trial,³⁷⁴ and only one case has concerned non-executive directors, the question must be examined in a broader way by looking at how the courts

³⁷¹ For pre-2006 see, for example, *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 W.L.R. 2, 12; *Re Fort Gilkicker Ltd* [2013] EWHC 348 (Ch); (2013) 163 N.L.J. 268 (Ch. D. (Companies Ct)); for post-2006 see Companies Act 2006, s. 260(3); Hansard HL Vol 679, Official Report 27/2/06 Col GC4

³⁷² *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 W.L.R. 2; *Pavlides v Jensen* [1956] Ch. 565; *Daniels v Daniels* [1978] Ch. 406

³⁷³ *Mission Capital Plc v Sinclair* [2008] EWHC 1339 (Ch); [2008] B.C.C. 866

³⁷⁴ *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 at [36]; *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 at [79]

have interpreted the new procedure and their criteria for allowing claims to continue to analyse whether this would allow claims against non-executives to proceed. If claims are likely to be allowed the derivative action could be an effective means for enforcement of fiduciary duties *ex post* against non-executives. However, as Reisberg argues:

[t]he success of any replacement to the common law action would best be judged not by the quantity of the case law generated under the new procedure, but by whether the rules governing the circumstances in which such an action may be brought are made more comprehensible and accessible so that, in exceptional circumstances, the commencement of a derivative claim will be regarded as a remedy worth pursuing instead of being ruled out at an early stage of a dispute as being far too difficult even to contemplate.³⁷⁵

One may assume from Lord Denning's comments that the courts will take a liberal approach in allowing claims to continue to a full trial. Yet, before the introduction of the 2006 Act, difficulties faced shareholders in enforcing the company's rights through a derivative action under the common law claim that may have negated any deterrent that fiduciary duties placed on directors. Several legal and practical obstacles to claims being successful, such as wrongdoer control³⁷⁶ and cost,³⁷⁷ made them rare in practice and were described as a weapon of last resort.³⁷⁸ Therefore, before 2006 at least, whilst fiduciary duties should in

³⁷⁵ A Reisberg, 'Shadows of the Past and Back to the Future: Part 11 of the UK Companies Act 2006 (in)action' (2009) 6(3) *European Company and Financial Law Review* 219

³⁷⁶ See, *Russell v Wakefield Waterworks Co* (1875) L.R. 20 Eq. 474, 482; *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch. 204, 219; B Cheffins and B Black, 'Outside Director Liability Across Countries' (2006) 84 *Texas Law Review* 1385, 1405; B Black *et al*, 'Legal Liability of Directors and Company Officials Part 2: Grounds for Liability (Report to the Russian Securities Agency) (2007) 3 *Columbia Business Law Review* 26; Law Commission Shareholder Remedies (Consultation Paper No 142 1996) (hereinafter 'Consultation Paper') paras 4.12-6, 14.2

³⁷⁷ See, for example, B Cheffins and B Black, 'Outside Director Liability Across Countries' (2006) 84 *Texas Law Review* 1385, 1403-1408

³⁷⁸ Hansard HL Vol 679, Official Report, 27/2/06 Col GC4

theory deter non-executives from acting against the interests of the company on any matters retained for by imposing strict liability for a breach of loyalty, the lack of credible enforcement for the shareholders of the company's rights may mean that the deterrent is ineffective. A workable enforcement mechanism for the shareholders is important then to deter non-executives from pursuing their own interests through such means as multiple appointments and increasing the chances that they provide appropriate governance within the firm.

The previous problems prompted reform and Part 11 of the Companies Act 2006 has introduced a new statutory derivative claim, which has replaced the exception from the common law.³⁷⁹ Derivative claims needed reform to reflect a more 'modern flexible and accessible criteria for determining whether a shareholder can pursue an action',³⁸⁰ with the aim of allowing cases to continue in appropriate circumstances.³⁸¹ The chapter will continue then by looking at whether this procedure is more comprehensible and accessible to ensure it is a remedy worth pursuing. First attention shall focus on the obstacles that faced a shareholder under the common law claim and the reasons behind the reform in the 2006 Act. This will provide much needed context to the discussion by identifying the difficulties that characterised the old common law procedure and assist in whether the claim is now more comprehensible and accessible to act as a deterrent for breach of fiduciary duty by non-executives.

³⁷⁹ Law Commission Report, para 6.55; *cf. Re Fort Gilkicker Ltd* [2013] EWHC 348 (Ch); (2013) 163 N.L.J. 268 (Ch. D. (Companies Ct))

³⁸⁰ Law Commission Report, para 6.15

³⁸¹ Law Commission Report, para 6.14

II. OBSTACLES TO ENFORCEMENT UNDER THE EXCEPTION IN FOSS

The exception to the rule in *Foss* gave shareholders a means of enforcing the company's rights against wrongdoers where those wrongdoers were in control of the company.³⁸² Without it there would be a wrong done to the company without a remedy. It was originally envisaged that establishing standing would be a short process in that a minority shareholder 'must establish a *prima facie* case (i) that the company is entitled to the relief claimed, and (ii) that the action falls within the proper boundaries of the exception to the rule in *Foss v Harbottle*'.³⁸³ The proper boundaries included the claimant proving *prima facie* that there was fraud on the minority, which required them to prove the wrongdoers were in control to show that the plaintiff was 'being improperly prevented from bringing these proceedings on behalf of the company'.³⁸⁴

There is an exception to the rule where what has been done amounts to fraud and the wrongdoers are themselves in control of the company. In this case the rule is relaxed in favour of the aggrieved minority, who are allowed to bring a minority shareholders' action on behalf of themselves and all others. The reason for this is that, if they were denied that right, their grievance could never reach the court because the wrongdoers themselves, being in control, would not allow the company to sue.³⁸⁵

Fraud on the minority was necessary since 'if something has been done illegally which the majority of the company are entitled to do legally, there can be no use in having a litigation about it, the ultimate end of which is only that a meeting has to be called, and then ultimately the majority gets its wishes'.³⁸⁶ Yet a claimant seeking to establish that their claim fell within these boundaries *prima facie* often faced several legal and practical difficulties.

³⁸² See, *Edwards v Halliwell* [1950] 2 All E.R. 1064, 1066-9

³⁸³ *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch. 204, 221-2

³⁸⁴ *Smith v Croft (No 2)* [1988] Ch. 114, 185

³⁸⁵ *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch. 204, 210; see also, Consultation Paper, para 16.21

³⁸⁶ *MacDougall v Gardiner* (1875) 1 Ch. D. 13, 25; see also, Consultation Paper, para 14.2

The matters of fraud and wrongdoer control were often complex matters of law³⁸⁷ that a judge would have to try to determine on the evidence it had before it since it was not yet a full trial.³⁸⁸ The requirements of establishing fraud and wrongdoer control *prima facie* meant a claim's legal merits had to satisfy a certain threshold to be permitted.³⁸⁹ Since ownership of public companies is widely dispersed it was often difficult to establish whether someone had effective control over the company, especially in larger companies where directors may have *de facto* control.³⁹⁰ Complex share ownership structures may also have made it difficult to determine who had control in small and large companies.³⁹¹ Furthermore, wrongdoer control was problematic because shareholders may have been apathetic to bring a claim. Therefore a shareholder with the wherewithal to bring a claim to enforce the company's rights would have been prevented from doing so because of the majority's apathy rather than some conscious decision from them to not enforce the company's rights.³⁹² Fraud did cover fiduciary breaches as it was not restricted to fraud at common law but included abuse of a power by a director³⁹³ such as a diversion of business opportunities.³⁹⁴ Fraud as a requirement alone then may not have restricted enforcement of fiduciary duties, but on the minority may have made it difficult to establish. These requirements would make the pursuit

³⁸⁷ See Consultation Paper, para 6.6

³⁸⁸ See, for example, *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 at [36]; *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 at [79]

³⁸⁹ See Law Commission Report, para 6.4; Consultation Paper, paras 6.6, 14.1-4, 16.21

³⁹⁰ See, Consultation Paper, paras 4.13, 14.2; *Smith v Croft (No 2)* [1988] Ch. 114; *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch. 204; *Pavlides v Jensen* [1956] Ch. 565; *Birch v Sullivan* [1957] 1 W.L.R. 1247 (Ch)

³⁹¹ See, for example, *Pavlides v Jensen* [1956] Ch. 565

³⁹² S Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119(6) Harv. Law Rev. 1735, 1752

³⁹³ *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 W.L.R. 2, 12; *Burland v Earle* [1902] A.C. 83, 93; *Daniels v Daniels* [1978] Ch. 406, 414

³⁹⁴ *Cook v Deeks* [1916] 1 A.C. 554 (PC)

of a claim against a non-executive difficult since it would be unlikely that a non-executive would have sufficient voting power to exercise effective control.³⁹⁵ Even if they did the claimant would still have to demonstrate their claim had sufficient legal merit, which may have been difficult given the lack of judicial understanding of non-executive fiduciary duties as evidenced in previous chapters.

The result of requiring a threshold to be met on the legal merits of the claim was lengthy proceedings often colloquially referred to as a “mini-trial”.³⁹⁶ These complex issues meant the cost of the claim could be high. Unless the minority could secure a Wallersteiner order,³⁹⁷ that meant the company would indemnify the costs of the claimant,³⁹⁸ they would have to bear the costs if the claim failed. Cheffins and Black have demonstrated that cost can be a serious disincentive to shareholder suits.³⁹⁹ Moreover, where a claim is successful, any benefit obtained would only be *pro rata* for the individual shareholders since the remedy sought is one for the company. The difficulties in establishing wrongdoer control and fraud against a non-executive would most likely have resulted in significant costs in any potential claim. Judges have also been reluctant to second-guess business decisions based on the “business-judgement rule”. Although not a strict legal rule, judges consider themselves ill

³⁹⁵ See B Cheffins and B Black, ‘Outside Director Liability Across Countries’ (2006) 84 *Texas Law Review* 1385, 1405

³⁹⁶ See, for example, *Smith v Croft* (No 2) [1988] Ch. 114 – where these preliminary issues took the court 18 days to resolve; *Trusthouse Forte plc v The Savoy Hotel plc* [1988] Ch. 114; Consultation Paper, para 6.6, 14.7

³⁹⁷ *Wallersteiner v Moir* (No 2) [1975] Q.B. 373

³⁹⁸ *Wallersteiner v Moir* (No 2) [1975] Q.B. 373, 403-4; *Smith v Croft* [1986] 1 W.L.R. 580 *per* Walton J

³⁹⁹ B Cheffins and B Black, ‘Outside Director Liability Across Countries’ (2006) 84 *Texas Law Review* 1385, 1403-1408

equipped to make commercial decisions.⁴⁰⁰ Thus, judges are unlikely to allow a claim to proceed where directors have made lawful decisions.

Faced with these obstacles, minority shareholders have generally preferred to bring an unfair prejudice petition.⁴⁰¹ An unfair prejudice petition can be brought by an individual shareholder personally on the grounds that there was either some breach of terms on which the member agreed that the affairs of the company should be conducted; or some use of the rules in a manner which equity would regard as contrary to good faith.⁴⁰² This offers a personal remedy and is not restricted by issues of *locus standi*. The petition need merely demonstrate that the conduct was unfair and prejudicial.⁴⁰³ Siems has noted that the 'use of the derivative claim will depend on its relationship to the unfair prejudice remedy'.⁴⁰⁴ It is important to elucidate the fact that a minority shareholder cannot simply choose which claim to bring. This is axiomatic from cases such as *Salomon v Salomon & Co Ltd*⁴⁰⁵ and *Foss*. Where a wrong is done to the company any loss suffered by shareholders is merely reflective of that of the company's loss.⁴⁰⁶ For example, where shareholders collectively

⁴⁰⁰ *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 at [85]; *Pavlides v Jensen* [1956] Ch. 565, 571

⁴⁰¹ Now under Companies Act 2006 sections 994-996

⁴⁰² *O'Neill v Phillips* [1999] 1 W.L.R. 1092, *per* Lord Hoffman

⁴⁰³ *Grace v Biagioli* [2006] EWCA Civ 1222; [2006] 2 B.C.L.C 70

⁴⁰⁴ M Siems, 'Private Enforcement of Directors' Duties: Derivative Actions as a Global Phenomenon', in S Wrba, S Van Uytsel and M Siems (eds), *Collective Actions: Enhancing Access to Justice and Reconciling Multilayer Interests?*, (Cambridge University Press, 2012) 93-116

⁴⁰⁵ *Salomon v Salomon & Co Ltd* [1897] A.C. 22

⁴⁰⁶ For further discussion on the reflective loss principle see, for example, *Kung v Kou* (2004) 7 HKCFAR 579; *Re Charnley Davies Ltd (No 2)* [1990] B.C.L.C. 760; S Griffin 'Shareholder remedies and the no reflective loss principle – problems surrounding the identification of a membership interest' (2010) 6 *Journal of Business Law* 461; H Hirt 'In what circumstances should breaches of directors' duties give rise to a remedy under ss.459-461 of

suffered a diminution in the value of their shares as a result of a wrong done to the company the loss would be fully remedied if the company enforced its rights. Any individual claims would be struck out since the company is the proper claimant.⁴⁰⁷ The reasons behind the reflective loss principle include the proper plaintiff rule, preventing double recovery and avoiding having assets moved out of the company to the detriment of the creditors.⁴⁰⁸ The derivative claim is therefore the primary remedy available to minorities for maladministration. Although rarely used in practice, the Law Commission did not see this as a reason not to reform it. The derivative claim may be the only appropriate or available route for the minority,⁴⁰⁹ thus making it accessible was a priority.

Overall the unlikelihood of proving *prima facie* non-executives had committed fraud on the minority whilst in control of the company, the costs that would be involved in proving it and the fact personal remedy could be available meant that under the common law claims against a non-executive were rare. The last reported derivative claim before 2006 against a non-executive was in 1981.⁴¹⁰ Yet with their increased role within the company, it seems unsatisfactory to not have workable means of enforcement against those who can act against the interests of the company that they undertook responsibility to protect.

the Companies Act 1985' (2003) 24(4) *Company Lawyer* 100; C Hale 'What's Right with the Rule in Foss v Harbottle?' (1997) 2 CFILR 219

⁴⁰⁷ See, for example, *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch. 204

⁴⁰⁸ *Johnson v Gore Wood & Co (No 1)* [2002] 2 A.C. 1, 62

⁴⁰⁹ Law Commission Report, para 6.11

⁴¹⁰ *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch. 204; see also, B Cheffins and B Black, 'Outside Director Liability Across Countries' (2006) 84 *Texas Law Review* 1385, 1407

III. STATUTORY REFORM

Part 11 of the Companies Act 2006 placed derivative claims on a statutory basis and replaced the common law exception.⁴¹¹ At the time it was seen as one of the most controversial aspects of the Act.⁴¹² Derivative claims needed reform to reflect a more 'modern flexible and accessible criteria for determining whether a shareholder can pursue an action',⁴¹³ with the aim of allowing cases to continue in appropriate circumstances.⁴¹⁴ However, directors were concerned that the increase in ways minority shareholders would be able to bring claims⁴¹⁵ and the reduced ability for the company to ratify breaches of duty⁴¹⁶ would allow minorities to bring frivolous litigation against them. Therefore the legislator was required to balance the need of directors to be able to take decisions without fear of frivolous reprisal against the company's interests of having its rights protected by ensuring those who control it act for its benefit. If the claim became too accessible claims may be more successful despite there being no illegal activity when going to full trial subsequently wasting time, reputation, money for the company and deter people from acting as directors. Conversely, making it inaccessible would result in wrongs being committed without an avenue for redress that Zhang argued would result in bad governance. This problem may be demonstrated through the following figures:

⁴¹¹ Law Commission Report, para 6.55

⁴¹² Hansard HL Vol 679, Official Report 27/2/06 Col GC3

⁴¹³ Law Commission Report, para 6.15

⁴¹⁴ Law Commission Report, para 6.14

⁴¹⁵ Companies Act 2006, s. 260 – Claims can now be brought 'only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company'

⁴¹⁶ Companies Act 2006, s. 239 – Directors are no longer able to vote on their own wrongdoing

Fig 1: Type I and II errors example 1

	Litigation allowed	Litigation not allowed
No breach	Business loses	Optimum
Breach	Business gains	Directors gain/shareholder losses

Fig. 2: Type I and II errors example 2

	Breach	No breach
Litigation allowed	Correct	Type II error
Litigation not allowed	Type I error	Correct

Whether litigation should or should not be allowed there needs to be a balance of the implications of type I and type II errors. To illustrate this point further there may be different regimes. For example, in a “god-like regime”, there would be:

Fig. 3: Type I and II errors example 3

	If breach ...	If no breach ...
litigation allowed ...	in 100% of cases.	in 0% of cases.
litigation not allowed ...	in 0% of cases.	in 100% of cases.

In a “random regime” (flipping a coin), there would be:

Fig. 4: Type I and II errors example 4

	If breach ...	If no breach ...
litigation allowed ...	in 50% of cases.	in 50% of cases.
litigation not allowed ...	in 50% of cases.	in 50% of cases.

in a “tough regime” there would be:

Fig. 5: Type I and II errors example 5

	If breach ...	If no breach ...
litigation allowed ...	in 80% of cases.	in 1% of cases.
litigation not allowed ...	in 20% of cases.	in 99% of cases.

whereas in a “soft regime” (i.e., allowing more claims) there could be:

Fig. 6: Type I and II errors example 6

	If breach ...	If no breach ...
litigation allowed ...	in 99% of cases.	in 20% of cases.
litigation not allowed ...	in 1% of cases.	in 80% of cases.

The aim may be to become “god-like” regime but the actual choice may be between tough and soft regimes and thus ultimately it should be determined whether Type I or Type II errors are more harmful. With this in mind the reform’s focus should be on making the procedure more accessible with a means of allowing claims to proceed in more appropriate circumstances, and not simply about making the claim more accessible. This reiterates Reisberg’s point that a significant quantity of cases will not demonstrate successful reform. Making it more accessible in appropriate circumstances may mean that a court is still heavily influenced by the legal merits of the claim.

Lord Goldsmith demonstrated that the new derivative claim would be a delicate balancing act. He opined directors should be able to take business decisions in good faith; but also allow shareholders to bring meritorious claims against directors but have unmeritorious claims dismissed at the earliest possible stage.⁴¹⁷ Hannigan reiterated the point saying that there must be a balance between promoting higher standards and not deterring people from

⁴¹⁷ Hansard HL Vol 681, Official Report, 9/5/2006, col 883

accepting directorships.⁴¹⁸ The fear was that if directors became subject to frivolous litigation, people would be unwilling to accept directorships. Bainbridge argues in a US context that ‘the system of corporate governance is designed to function largely without shareholder input’,⁴¹⁹ which is echoed in the Law Commission’s guiding principle that there should be a freedom from shareholder interference.⁴²⁰ The rhetoric from Parliament was that there were already sufficient safeguards in place to protect from frivolous claims.⁴²¹ Regardless, they eventually responded to these concerns. The Law Commission argued that it was ‘preferable to avoid the possibility of such nuisance claims being brought at all’.⁴²² The end result was a two-stage test to assess all relevant circumstances to the claim.

This two-stage test aimed to remove the difficulties that characterised the common law claim, which the Law Commission saw as complicated and unwieldy.⁴²³ The Commission recommended that a statutory procedure should entirely replace the common law claim.⁴²⁴ This new procedure would allow the courts to apply its discretion as to whether a claim should be allowed by considering all the relevant circumstances⁴²⁵ and removing any

⁴¹⁸ B Hannigan, *Company Law*, (2nd edn OUP, 2009) 229; see also, H Hirt, ‘The review of the role and effectiveness of non-executive directors: a critical assessment with particular reference to the German two-tier board system: Part 2’ (2003) 14(8) *International Company and Commercial Law Review* 261, 266

⁴¹⁹ S Bainbridge, ‘Shareholder Activism and Institutional Investors’ (2005) <<http://ssrn.com/abstract=796227>> accessed 7th April 2010

⁴²⁰ Consultation Paper, para 14.11 (v)

⁴²¹ Such as any sums recovered would be returned to the company and if the claim is unsuccessful the claimant may incur substantial costs; see A Reisberg ‘Derivative actions and the funding problem: the way forward’ (2006) *Journal of Business Law* 445

⁴²² Law Commission Report, para 6.45

⁴²³ Law Commission Report, para 6.4

⁴²⁴ Law Commission Report, para 6.55

⁴²⁵ Law Commission Report, para 6.73

threshold or merits test in proving control and fraud on a *prima facie* basis.⁴²⁶ The Commission recommended that 'it would clearly be wrong for the court to allow an obviously hopeless case to proceed. But we consider that it would be undesirable to encourage parties to bring evidence to show that a case met or failed to meet a particular merits test'.⁴²⁷ Seemingly then the merits of the claim would be considered but the claim would not have to demonstrate sufficient merit by itself to proceed in every instance. It was hoped that by giving the court the discretion to allow a claim on all the relevant circumstances and removing any threshold test would reduce the time and cost of litigation.⁴²⁸ However, the Commission did recognise that cost and time would still need to be spent on certain areas when granting permission.⁴²⁹ Roberts and Poole have also been sceptical as to whether time and cost savings are an achievable objective. They argued that derivative claims are based on leave and judicial control and so 'it seems to automatically follow that this mechanism is unlikely to result in reduced costs and time saving'.⁴³⁰

The Commission also sought to make the claim available on wider grounds and recommended that a claim should not be restricted to fraud or *ultra vires*. They considered that a claim should be available for negligence, default, breach of duty or breach of trust.⁴³¹ The reform also wished to remove any requirement of wrongdoer control. They acknowledge that a shareholder may bring a claim,⁴³² thus not necessarily a minority, and that where the

⁴²⁶ Consultation Paper, para 16.22

⁴²⁷ Law Commission Report, para 6.71

⁴²⁸ Law Commission Report, para 6.4

⁴²⁹ Law Commission Report, para 6.79

⁴³⁰ P Roberts and J Poole, 'Shareholder remedies – corporate wrongs and the derivative action' (1999) *Journal of Business Law* 99, 102

⁴³¹ Law Commission Report, para 6.47; see also Hansard HL Vol 679, Official Report 27/2/06 Col GC3; Companies Act 2006, s. 260(3)

⁴³² Law Commission Report, para 6.50

wrong is yet to be ratified then this will not prevent a claim from proceeding.⁴³³ Yet where that wrong has been ratified this will be a bar to a claim. This may be problematic considering ratification pre-2006, since the shareholder would need to demonstrate wrongdoer control regarding that purported ratification to bring a claim⁴³⁴ and whether ratification was lawful was an uncertain topic but it had been considered that it was unlawful where it impeded the company from enforcing its right and was brought about by improper means.⁴³⁵ However, what is a ratifiable wrong seems to be overcome by section 239, which prevents wrongdoers and connected persons from voting on any purported ratification leaving the disinterested majority to decide.⁴³⁶ The Commission also noted that ‘in the absence of circumstances justifying the grant of leave, we consider that the proper plaintiff principle should apply since... it is fundamental to any rational system of jurisprudence’.⁴³⁷ Thus it seems unlikely that issues of wrongdoer control have been completely removed from by the reform.

The relationship between the unfair prejudice remedy and the derivative claim may remain the same in terms of the difficulties it can cause in making the latter a suitable remedy. The unfair prejudice remedy will still offer no standing restrictions as well as a giving a personal remedy whereas the derivative claim is still a remedy for corporate relief with the risk that costs may have to be incurred by the claimant. However, making the claim more accessible for when the remedy sought is corporate relief may mean that the relationship between the two is complimentary rather than hierarchal.

⁴³³ Law Commission Report, para 6.86

⁴³⁴ Law Commission Report, para 6.81

⁴³⁵ *North-West Transportation v Beatty* (1887) 12 App. Cas. 589; see also A Keay and J Loughrey, ‘Derivative proceedings in a brave new world for company management and shareholders’ (2010) 3 *Journal of Business Law* 151

⁴³⁶ Companies Act 2006, s. 239

⁴³⁷ Law Commission Report, para 6.93

The objectives of the reform appear to be based on reducing the time and cost of a claim with a more flexible procedure in giving the court discretion to consider all the relevant circumstances and removing any threshold test relating to the merits of a claim on restrictive grounds in an effort to allow more claims to proceed in more appropriate circumstances but also prevent any vexatious or frivolous litigation. If these objectives have been achieved the company may have a more prominent means of ensuring non-executives act for the benefit of the company. Whether they have requires an investigation in to the new statutory procedure and judicial interpretation concerning these previous difficulties in the common law claim.

IV. COMPANIES ACT 2006 PART 11: A MEANINGFUL PURSUIT?

a. Is the claim more accessible? A prima facie case

Before the company becomes involved in the standing provisions of a derivative claim, the claimant must make an *ex parte* application that discloses that they have a *prima facie* case. This is the first stage the claimant must pass in the new statutory procedure under section 261(2). If the evidence does not disclose a *prima facie* case then the claim must be dismissed. This stage was introduced to prevent frivolous or vexatious claims and prevent the company being involved in unnecessary litigation by requiring the claimant only to submit evidence.⁴³⁸ The Law Commission was reluctant to even include the first stage as it would increase the risk of a detailed investigation.⁴³⁹ The introduction of this first stage may then deter claimants from pursuing an action. Whether the claim is initially more accessible for claims against non-executive fiduciary breaches it needs to be considered what is required to demonstrate a *prima facie* case and how the courts have approached it so far.

⁴³⁸ Hansard, HL Vol 681, col 883 (May 9, 2006)

⁴³⁹ Consultation Paper, para 14.11 (v), 16.21-16.22; Law Commission Report para 6.71

Part 11 of the 2006 Act requires, for there to be a *prima facie* case, that a member⁴⁴⁰ is bringing a cause of action vested in the company in respect of ‘an actual or proposed act or omission involving, negligence, default, breach of duty or breach of trust by a director of the company’.⁴⁴¹ This wording suggests that establishing a *prima facie* case is less burdensome on a shareholder and more accessible against a non-executive. The requirement makes no mention of fraud on the minority or that the company has been improperly prevented from enforcing its rights. There simply needs to be a breach of duty by a director of the company for the court to grant interim permission to a shareholder. This would mean that where a non-executive has breached their duty a shareholder could bring a claim.

Despite the low threshold that the first stage sets out, one claim under the new procedure has suggested a higher standard has to be met. This was the case in *Stimpson v Southern Landlords Association* where it was considered that a court in considering an *ex parte* application could consider all relevant circumstances,⁴⁴² which form the second part of the procedure under section 263(3). Also in *Stainer v Lee* the court opined that the relationship between section 261(2) and 263(3) might not be so stark.⁴⁴³ However, *Iesini v Westrip Holdings Ltd* acknowledges that there must be a difference between establishing a *prima facie* case and the court’s discretion at the second stage:

In order for a claim to qualify under Part 11 Chapter 1 as a derivative claim at all ... the court must, as it seems to me, be in a position to find that the cause of action relied on in the claim arises from an act or omission involving default or breach of duty (etc.) by a director. I do not consider that at the second stage this is simply a matter of establishing a *prima facie* case ...

⁴⁴⁰ Companies Act 2006, s. 260(1)

⁴⁴¹ Companies Act 2006, s. 260(3)

⁴⁴² *Stimpson v Southern Landlords Association* [2009] EWHC 2072 (Ch); [2010] B.C.C. 387 at [46]; see also A Keay and J Loughrey, ‘Derivative proceedings in a brave new world for company management and shareholders’ (2010) 3 *Journal of Business Law* 151, 155

⁴⁴³ *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [29]

as was the case under the old law, because that forms the first stage of the procedure. At the second stage *something more* must be needed. If the court analyses questions of wrongdoer control and the merits of the case on the basis of the initial application it will fail to meet those objectives set out in the reform.⁴⁴⁴ (emphasis added)

It is considered that this must be the correct interpretation of the new procedure. It seems unlikely that it was the intentions of Parliament to simply repeat in the second stage what has been considered in the first. Furthermore, the Act under section 261(2) makes no reference to the court's discretion as to whether there is a *prima facie* case. The Act simply provides that the claim must relate to negligence, default, breach of duty or breach of trust by a director in respect of an action vested in the company. Lord Goldsmith has added that at this stage it would be enough if there is a risk that a duty had been breached.⁴⁴⁵ It seems if the claimant is a shareholder and it is evidenced that their *ex parte* application satisfies these criteria they will establish a *prima facie* case. A further reason mentioned in *Iesini* to reject the suggestion that the courts will use its discretion available in the first stage is that in doing so it would mean the claim does not meet the intended objectives. If the courts attempt to assess matters such as the merits of the claim and wrongdoer control on the initial application there is little chance that costs and time will be reduced or claims being allowed to proceed in appropriate circumstances given that it is only the applicant producing any evidence at this point. Finally, six of the following cases have cited the judgment in *Iesini*.⁴⁴⁶ Notably the judgment in *Stainer v Lee* acknowledged that the court's discretion required something more than a *prima facie* case; but continued that the relationship between section

⁴⁴⁴ *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 at [79]

⁴⁴⁵ Hansard HL Vol 681, Official Report, 9/5/2006, col 888

⁴⁴⁶ *Phillips v Fryer* [2012] EWHC 1611 (Ch); [2013] B.C.C. 176 at [15]; *Parry v Bartlett* [2011] EWHC 3146 (Ch) at [73]; *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) L.S.G. 19 at [39]; *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [29]; *Kiani v Cooper* [2010] EWHC 577 (Ch); [2010] B.C.C. 463 at [12]

261(2) and section 263(3) may not be so stark because the court may revise its decision as to whether there is a *prima facie* case at this point.⁴⁴⁷

Whilst the statutory language may suggest that the *ex parte* application would not be a significant obstacle to a claim for breach of fiduciary duty the courts application of the test may prove otherwise. Table A demonstrates how the courts have approached the initial application.

Table A: Prima Facie decisions

Case	Prima Facie Case		Reason
	Yes	No	
Bamford	•		Interim permission
Cinematic Finance	•		Interim permission
Fanmailuk	•		Not contested
Franbar	•		Defendant conceded
Hughes	•		N/A
Iesini	•		Interim permission
Kleanthous	•		Interim permission
Kiani	•		Interim permission
Mission Capital	•		Not discussed/Not a duplicative claim (see table b)
Parry	•		Interim permission
Phillips	•		N/A
Seven Holdings	•		Not contested; judge highly critical that it had not been observed; Would have dismissed if had been heard
Stainer	•		Interim permission
Stimpson	•		“Unduly elaborate” to discuss as it was clear there was one

This first stage does not appear to be particularly burdensome on the applicant with all 14 cases successfully being given permission to continue to the second stage. Therefore the first stage should do little to deter the shareholder seeking to enforce the company’s rights for breach of fiduciary duty by a non-executive. Notably six cases have not even observed the first stage, which is surprising given that it is a statutory procedure.

⁴⁴⁷ *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [29]; cf. *Re Seven Holdings Ltd* [2011] EWHC 1893 (Ch) – where the judge dismissed the claim for a mandatory bar despite evidence revealing there was no *prima facie* case

A few reasons have been offered as to why the first stage is a fairly easy matter to overcome. Hannigan argued that the courts faced with a new procedure, that is designed to make claims more accessible are unlikely to dismiss a claim at the first stage.⁴⁴⁸ It is also unlikely that a lawyer would construct an application that did not at least disclose a *prima facie* case. Australian authority concerning applications has also considered that ‘...[I]t is inappropriate to consider in any detail the standard of probability of the plaintiff’s case. It is enough to say at this stage that the issue is ‘triable’ or ‘arguable’.’⁴⁴⁹ The latter two arguments are considered more likely explanations for all claims being successful as it seems unlikely that a court will allow claims based on making them more accessible since this seems contrary to the desire of having the first stage to filter out frivolous pursuits by shareholders.

The *ex parte* application is unlikely to deter would be applicants from pursuing a claim. The criteria to satisfy are not particularly burdensome, as the court does not apply any of its discretion at this stage. It simply seeks to establish if the claim relates to a breach of duty by a director in respect of an action vested in the company. Therefore a shareholder who believes a non-executive has committed a breach of their fiduciary duty can initially seek corporate relief through a derivative claim.

The wording, although not the actual decision, in *Stimpson* has suggested that the procedure may also be flexible in allowing the court to use its discretion in the *ex parte* application, as well as ignoring this stage entirely where the court deemed it “unduly

⁴⁴⁸ B Hannigan, *Company Law*, (2nd edn OUP, 2009) 451; see also Hansard HL Vol 679, Official Report, 27/02/2006, col GC14

⁴⁴⁹ *Australian Broadcasting Corp v Lenah Game Meat* (2001) 185 ALR 1

elaborate” to establish whether such a case had been made out.⁴⁵⁰ Theoretically this may result in time and cost savings, which could potentially encourage more applications against non-executives. Yet, Parliament saw the *ex parte* application as necessary and not to be ignored entirely to ensure frivolous litigation was deterred. The recent case of *Re Seven Holdings Ltd* appears to support rigidity of procedure. The court was highly critical of the fact the first stage had been ignored. The judge was aggrieved with the fact he was hearing a case that had not made out whether there was a *prima facie* case. This was exacerbated by the fact that most of the claims did not relate to a breach of duty, breach of trust, default or negligence. He went on to note that if the initial stage had in fact been heard in this instance it would have saved the parties and the court a significant amount of time and money.⁴⁵¹ Furthermore, the suggestion that the discretion may be applied at the first stage may be appropriate in theory, because it would stop a case that would clearly not survive that stage earlier on and not give the claimant false hope. However, given that the *ex parte* application is submitted on rudimentary evidence it may incentivise the wrongdoers to withhold evidence, making it harder to prove any wrongdoing. This appears to have already happened in two cases.⁴⁵² Therefore the flexibility unilaterally applied by the courts and parties may in fact hinder the accessibility and transparency of the remedy. Seemingly the courts are taking their discretion too far in attempt to create a flexible procedure, attempts which may in fact have the opposite effect to the desired outcomes and deter claims against non-executives from being pursued.

What is apparent is that in practice the *ex parte* application is of little hindrance to a claim. There is no longer a merits based assessment or threshold test at this stage so a

⁴⁵⁰ *Stimpson v Southern Landlords Association* [2009] EWHC 2072 (Ch); [2010] B.C.C. 387 at [3]

⁴⁵¹ *Re Seven Holdings Ltd* [2011] EWHC 1893 (Ch) at [61]-[63]

⁴⁵² *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885; *Kiani v Cooper* [2010] EWHC 577 (Ch); [2010] B.C.C. 463

shareholder may be encouraged to apply if they feel a director has committed a wrong. Yet there are a few worrying developments that applicants may need to be wary of concerning how the procedure is to be followed. However, given the apparent acceptance of *lesini* in recent cases may mean in the long term this will not be a problem, although *Seven Holdings* has acted as a reminder as to why the procedure should be followed if the objectives of the reform are to be met.

b. Merits of a claim, the court's discretion and granting permission

The Commission sought to make the claim more accessible to allow claims to continue in more appropriate circumstances. Some of the fundamental ways they saw to do this was increase the grounds for bringing a claim and to removal of merits or thresholds tests;⁴⁵³ giving the court the power to dismiss claims that had no realistic chance of success;⁴⁵⁴ and requiring the court to consider all the relevant circumstances of a claim.⁴⁵⁵

The grounds on which a claim may be pursued have widened,⁴⁵⁶ but a claim could be brought for fiduciary breach before 2006. However, the removal of a claim needing to demonstrate sufficient legal merit that there was fraud on the minority and allowing the court to consider all relevant circumstances may mean that pursuing a non-executive for breach of fiduciary duty is easier. Whilst there is no specific bar to a claim if the shareholder fails to demonstrate significant merit to their claim⁴⁵⁷ the Commission endorsed the fact that the courts should not allow a completely hopeless claim to proceed. Therefore, considering the merits of the claim to some extent is unavoidable and the court must apply its discretion at

⁴⁵³ Law Commission Report, para 6.72

⁴⁵⁴ Law Commission Report, para 2.13

⁴⁵⁵ Law Commission Report, para 6.73

⁴⁵⁶ Companies Act 2006, s. 260(3)

⁴⁵⁷ For discussion on whether there should have been see, Hansard HL Vol 681, Official Report, 9/5/2006, col 887-8; Consultation Paper, para 16.22

the second stage,⁴⁵⁸ after an *ex parte* application has been granted. It is worth considering then how the court applies its discretion in respect of the legal merits of the claim and how it is considered in respect of other circumstances relevant to granting permission. If the courts place too much emphasis on the legal merits, a claim for breach of duty by a non-executive may be faced with similar problems that faced the common law claim such as proving to a sufficient threshold that the activity was unlawful and the costs involved with doing so.

Whilst there is no specific direction in the statute for the court to consider the legal merits of the claim when applying its discretion the court is required to refuse permission if the facts disclose that a director acting in accordance with section 172 would not continue the claim; and if the claimant satisfies this test then under the court must take in to account section 263(3), *inter alia*, the importance that a person acting in accordance with section 172 would attach to continuing it. Section 172 itself requires a director to act in a way he considers to promote the success of the company. Therefore a director considering litigation is likely to consider the legal merits of the claim when considering whether to commence proceedings since any benefit is for the company. However, there is a difference between section 172 and the statutory derivative claim. Under section 172 the courts would have no power to interfere where the director had properly formed a good faith view; but in the latter the court has to formulate its own view as to how much weight a director would attach to continuing the claim.⁴⁵⁹ In *Mission Capital plc v Sinclair* the court noted that 'section [s263(3)(b)] refers to a notional director considering whether to continue a claim. It is of course not the actual board of the company'.⁴⁶⁰

⁴⁵⁸ Companies Act 2006, ss. 263(2)(a), 263(3)

⁴⁵⁹ P Davies, *Gower and Davies: Principles of Modern Company law* (8th edn Thomson/Sweet & Maxwell, 2009)

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⁴⁶⁰ *Mission Capital Plc v Sinclair* [2008] EWHC 1339 (Ch); [2008] B.C.C. 866 at [38]

i. Mandatory bar

The first instance the court is able to consider the legal merit of any claims is when the court must refuse permission for a mandatory bar. Mandatory bars would be considered before the discretion of the court since they require lower standards of proof to satisfy the court. This mandatory bar has been interpreted to mean that 'section 263(2)(a) will apply only where the court is satisfied that *no director* acting in accordance with section 172 would seek to continue the claim'.⁴⁶¹ *Franbar Holdings Ltd v Patel* has also noted that where there is room for more than one view that some directors may want to pursue the claim then this will satisfy the test.⁴⁶² However "something more"⁴⁶³ is needed than establishing a *prima facie* case. It is not enough that the claim relates to a breach of duty etc. it must also be shown that some directors would consider continuing the claim.⁴⁶⁴

Table B shows that three cases have been dismissed for a mandatory bar under section 263(2)(a). What the court considers a director acting in accordance with section 172 would take in to account when deciding whether to pursue a claim may be more than just the legal merits, including cost and potential recovery, of the claim.

⁴⁶¹ *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 at [86]; approved in *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [28]

⁴⁶² *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 at [30]

⁴⁶³ *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 at [79]; *cf. Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [29]; *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) L.S.G. 19 at [40]; *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [33]

⁴⁶⁴ *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 at [30]

Table B: Mandatory Bars

Case	Mandatory Bar		Reason
	Yes	No	
Bamford		•	Claim not based on any of the grounds in s.263(2)
Cinematic Finance		•	Not discussed
Fanmailuk		•	Not discussed; adjourned
Franbar		•	Room for more than one view on the facts
Hughes		•	No authorisation as to the transfer of assets; clear from second stage that it could not be said no director acting in accordance with section 172 would continue the claim
Iesini	•		Dismissed and adjourned; Legal claim very weak; assets unlikely to cover costs and loss; s994 unfair prejudice petition available
Kleanthous		•	Not satisfied claim was weak enough that no director would continue, except against one defendant director
Kiani		•	Many factual disputes
Mission Capital		•	Claim not duplicative of the counterclaim brought by the claimants where the company had obtained injunctive relief to exclude the claimants from the premises after they terminated their employment. The derivative claim may succeed where the counterclaim failed
Parry		•	Cannot be said no director would seek to continue the claim/conduct not ratified or authorised
Phillips		•	N/A
Seven Holdings	•		Although dismissed under s260(3) it would have also been dismissed under s263(2)(a)
Stainer		•	Applied Iesini test as to whether no director acting in accordance with s172 would continue; Not a threshold test and declared no mandatory bar
Stimpson	•		Benefits negated by detriments; e.g. only one realistically arguable point; claim more likely to be worth £200,000 not £5.3m; cost of claim will be difficult to recover

In *Franbar* the court considered that a director acting in accordance with section 172 would consider:

Such matters as the prospects of success of the claim, the ability of the company to make a recovery on any award of damages, the disruption which would be caused to the development of the company's business by having to concentrate on the proceedings, the

costs of the proceedings and any damage to the company's reputation and business if the proceedings were to fail. A director will often be in the position of having to make what is no more than a partially informed decision on continuation without any very clear idea of how the proceedings might turn out.⁴⁶⁵

Despite this list of matters the court may consider the judge did not actually go beyond the legal merits of the claim in his assessment of whether a hypothetical director would continue the claim and how much weight they would attach to it.⁴⁶⁶ The reasons behind this may be seen in *Iesini*:

[A hypothetical directors may consider] the size of the claim; the strength of the claim; the cost of the proceedings; the company's ability to fund the proceedings; the ability of the potential defendants to satisfy a judgment; the impact on the company if it lost the claim and had to pay not only its own costs but the defendant's as well; any disruption to the company's activities while the claim is pursued; whether the prosecution of the claim would damage the company in other ways (e.g. by losing the services of a valuable employee or alienating a key supplier or customer) and so on. The weighing of all these considerations is essentially a commercial decision, which the court is ill-equipped to take, except in a clear case.⁴⁶⁷

The judgment continued that in assessing whether no director would consider continuing the claim it is not a matter of assessing whether the claim relates to a breach of duty etc. but to 'form a view on the strength of the claim in order properly to consider the requirements of section 263(2)(a) and 263(3)(b)'.⁴⁶⁸ *Iesini* was quite explicit in the fact that it would consider the merits of the claim.⁴⁶⁹

⁴⁶⁵ *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 at [36]

⁴⁶⁶ *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 at [28]-[30]; See also D Kershaw, *Company Law in Context: Text and Materials*, (2nd edn OUP, 2012) 615

⁴⁶⁷ *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 at [85]

⁴⁶⁸ *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 at [79]

⁴⁶⁹ *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 at [88]

The early case law, particularly *lesini*, seems to suggest then that where the merits of the legal claim are weak this will bar a claim and therefore the procedure has failed to remove a merits based test for allowing claims to continue, albeit a lower threshold than proving *prima facie* there has been a breach and now only that some directors would pursue such a claim. Certainly this will be the situation when the court deliberates as to whether there is a mandatory bar since at this stage the procedure does not require the court to consider other relevant circumstances like it does under section 263(3) when considering the importance a director acting in accordance with section 172 would attach to the claim. Two of the three cases dismissed so far for a mandatory bar have been so on the grounds that the legal claim was weak. In *lesini* it was not clear whether the claim related to breach of duty or negligence and in *Seven Holdings* the claims did not in fact relate to a breach of duty, breach of trust, default or negligence. Whilst *Stimpson* did go as far as considering commercial considerations, this case concerned a company limited by guarantee and could properly be described as a “clear case” like that mentioned in *lesini*.

Yet this requirement that the legal claim demonstrate sufficient merit so that some directors would consider pursuing it may not hinder the accessibility of a claim for breach of fiduciary duty. This is because a breach of fiduciary duty may be easier to establish initially and so the merits of the legal claim may be greater. The duty itself has been described generally as “so well settled”⁴⁷⁰ – albeit with some lack of clarity in respect of specific application to directors – and with strict liability it may be difficult for the director to show they did not act with self-regard over the interests of the principal.⁴⁷¹ For example, in *Franbar* there was a strong suggestion that the director had been diverting business opportunities,⁴⁷² and in *Stainer v*

⁴⁷⁰ *Boardman v Phipps* [1967] 2 A.C. 46, 125

⁴⁷¹ See, L Smith, ‘The motive, not the deed’ in J Getzler (ed), *Rationalizing Property, Trusts and Equity: Essays in honour of Edward Burn* (Butterworths, 2003) ch 4

⁴⁷² *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 at [30]

Lee there were strong grounds of breach of duty where the directors had failed to charge interest on a loan to a company they were interested in.⁴⁷³ Even if the company fails to produce or withholds evidence that may demonstrate a breach then the court may allow a claim down to disclosure as they did in *Kiani v Cooper*. However, this may increase the time and cost of the claim to the detriment of the claimant, as in *Kiani* the respondents had six weeks to produce the evidence required but had failed to do so.⁴⁷⁴ Also it may not hinder the accessibility since a breach of section 175 may be quantifiable and so the cost of the claim may be easier to establish. In *Stimpson* the importance of the cost benefit ratio was highlighted as to the claim's merit. They noted that from the claim that whilst around £200,000 would be realistically recoverable, this would be outweighed by the cost of the claim.⁴⁷⁵ As such, *inter alia*, they concluded that no director would continue.

The requirement that the legal merits of the claim be strong enough to not be barred from continuing should not greatly hinder its accessibility since only two of the fourteen cases concerning a fiduciary breach have been barred. Initially it seems that the removal of requiring the claimant to prove *prima facie* fraud on the minority and replacing it with this mandatory bar will make the claim more accessible. The claimant need only show that the non-executive acted with self-interest to a point where some directors would continue the claim and not to the extent that it is proved *prima facie*. This, coupled with the fact a claim may be brought against a non-executive for breach of duty, shows signs that a derivative claim against a non-executive may be a viable option of enforcement by a shareholder for the company.

⁴⁷³ *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [34]

⁴⁷⁴ *Kiani v Cooper* [2010] EWHC 577 (Ch); [2010] B.C.C. 463 at [30]

⁴⁷⁵ *Stimpson v Southern Landlords Association* [2009] EWHC 2072 (Ch); [2010] B.C.C. 387 at [40]

ii. Court's discretion

Despite the legal merits not needing to be as strong under section 263(2) than under the common law, suggesting a more accessible claim, the courts will revisit the merits of the legal claim when applying its discretion under section 263(3). The requirement under section 263(3)(b) that the court must consider the importance a director acting in accordance with section 172 would attach to a claim would require more than the minimum that what would satisfy section 263(2)(a) for the court to consider it an advantage to granting leave. If the hypothetical director would attach little weight to the claim then it is unlikely to count for the shareholder in granting permission since the benefit of the claim is for the company.⁴⁷⁶ Therefore this section also needs to be considered as to whether the required merits of the legal claim hinder the accessibility for breach of fiduciary duty.

Under section 263(3) the strength of the legal merits must also be considered against the other circumstances the court is directed to consider when applying its discretion to give leave. The judge under section 263(3) does not just consider the importance a director would attach to the claim but must also consider factors such as whether the claimant is acting in good faith in bringing a claim, whether there is an alternative remedy, whether the company has decided not to pursue the claim, and the likelihood of the actions or omissions being ratified as well as any other relevant circumstances.⁴⁷⁷ If the shareholder cannot demonstrate stronger legal merit at this stage than they did under section 263(2)(a) this may not necessarily mean permission is refused if other circumstances reveal permission should be allowed.⁴⁷⁸ Lord Goldsmith has noted that when the court applies its discretion in

⁴⁷⁶ *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 at [35]; *cf. Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [29]; *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) L.S.G. 19 at [40]; *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [33]

⁴⁷⁷ See *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 at [31]

⁴⁷⁸ *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [29]

assessing these factors that there is no hierarchal or “step-by-step” approach.⁴⁷⁹ Whilst a director may attach little importance to the claim, other considerations may still demonstrate that permission should be granted. However, given that the reform intended claims to proceed in appropriate circumstances the merits of the legal claim are likely to be a significant consideration for the court.

So far 35.7% of claims under the new procedure have been granted permission. From the table it is observed several claims have considered the strength of the legal claim such as *Franbar*, *Kleanthous v Papithis*, *Stainer*, *Kiani*, and *Mission Capital*. The claims so far offer different views on how important the strength of the legal claim is to granting permission, but it is clear that the intended objective of reform was that it was only one consideration amongst all other relevant considerations.⁴⁸⁰

Some of the first cases heard under the new procedure such as *lesini*, *Stimpson* and *Franbar* seem to place significant emphasis on the merits of the legal claim. *Stimpson* stated that realistically arguable claims are not sufficient;⁴⁸¹ whilst in *Franbar* the court said there was “no obvious breach of duty”⁴⁸² (emphasis added). *lesini* also added that something more was needed than establishing a *prima facie* case.⁴⁸³ Some of the more recent decisions though, such as *Kleanthous* and *Stainer*, appear to support the view that it is only one consideration.

⁴⁷⁹ Hansard HL, Vol 679, Official Report, 27/2/2006 Col GC26

⁴⁸⁰ *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [29]

⁴⁸¹ *Stimpson v Southern Landlords Association* [2009] EWHC 2072 (Ch); [2010] B.C.C. 387 at [34]

⁴⁸² *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 at [37]

⁴⁸³ *lesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 at [79]

Table C: Permission

Case	Permission		Reason
	Yes	No	
Bamford		•	Company was the proper plaintiff. Although not a bar it was clear the company could commence the proceedings by itself. Also remedy available through shareholders' agreement
Cinematic Finance		•	Could not circumvent the insolvency regime by commencing a derivative claim; controlling shareholder and lack of exceptional circumstances for a majority to bring a claim
Fanmailuk		•	Case adjourned
Franbar		•	Availability of s994 and breach of shareholders' agreement; no obvious breach of duty; some breaches may be ratified
Hughes	•		<i>Inter alia</i> : Derivative claim was more appropriate based on the remedy sought; the issue of costs to the company was not substantial to deny the claim as it would be unlikely to pay if the respondent was successful
Ilesini		•	Mandatory bar
Kleanthous		•	Case of little strength and size; views of disinterested members and committee suggested it was not worth continuing; s994 claim available; recovery would be distributed pro rata
Kiani	•		Down to disclosure; No corroborative evidence produced to the contrary
Mission Capital		•	Little weight to pursuing a claim for wrongful dismissal of a director; availability of s994
Parry	•		Appropriate to grant pre and post 2006
Phillips	•		Matter of case management that required the case to be brought quickly and economically before the court to recover the funds taken from the company without good reason
Seven Holdings		•	Mandatory bar; availability of a winding up order in a deadlocked company
Stainer	•		Down to disclosure and subject to a ceiling on costs of £40,000. Not paying interest on a loan, that partially had no obvious reason, over many years creates very strong grounds that fiduciary duties were breached; potential disinterested shareholders were deceived in approving the loan
Stimpson		•	Mandatory bar; even if judge was wrong he would have dismissed at his discretion

In *Stainer* the court formed the opinion that ‘section 263(3) and (4) do not prescribe a particular standard of proof that has to be satisfied but rather require consideration of a range of factors to reach an overall view’.⁴⁸⁴

To require a high standard of proof seems to go against the objectives of reform to make the claim more accessible and continue in appropriate circumstances. Such an approach seems close to what was required under fraud on the minority. *Kleanthous* noted the new statutory claim was introduced to remove any threshold tests on the merits of the claim⁴⁸⁵ and supported *Stainer* that an overall view on whether the claim should be allowed at the discretion of the court. This discretion, according to *Stainer*, meant a very weak claim where a lot of money could be recoverable would, with all other things being equal, have just as much chance of success of a very strong claim where the value of the claim was small.⁴⁸⁶

A problem with a threshold test is that they can place a greater onus on the claimant who is in the weaker position. Cases such as *Franbar* and *Kiani* significantly demonstrate this. In *Franbar* the respondents were withholding information from the claimant. Such a move will make it difficult for the claimant to demonstrate an “obvious breach of duty”. In *Kiani* the respondents failed to produce any corroborative evidence despite having six weeks to do so. This tactic can undoubtedly delay proceedings at increased cost to the claimant. Importantly, *Kiani* did receive permission to continue though but only down to disclosure but it goes to show that they had a stronger case since the respondents did not produce any evidence to the contrary. A similar set of circumstances occurred in *Stainer* as well.⁴⁸⁷ This does

⁴⁸⁴ *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [29]; cited by *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) L.S.G. 19 at [39]; *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [33]

⁴⁸⁵ *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) L.S.G. 19 at [41]

⁴⁸⁶ *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [27]

⁴⁸⁷ *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [37]

suggests if the respondents do eventually produce some evidence the court will be reluctant to allow the claim to continue.

There are also issues with general information asymmetries between shareholders and the company. Necessitating an obvious breach of duty will be conducive of deterring would be applicants. It appears the position taken from *Stainer*, and supported by *Kleanthous*, should undoubtedly be taken as the correct approach, although *Iesini* was correct in part that something more than a *prima facie* case should be shown for the merits of the claim to count towards permission being granted. Whilst the court considers the strength of the claim, it recognises this is just one consideration of many and the courts should be free to exercise that judicial discretion to satisfy the objectives of the reform. Whilst ‘the merits of the claim are relevant to whether permission should be given ... there should no such threshold’.⁴⁸⁸ This approach will make claiming against non-executives less onerous as it does not require overbearing standards of proof on the claimant, which may not be possible at the application stage. After all in *Franbar* it was stated that directors ‘will often be in the position of having to make what is no more than a partially informed decision on continuation without any very clear idea of how the proceedings might turn out’;⁴⁸⁹ and in *Iesini* they observed that ‘any view can only be provisional where the action has yet to be tried; but the court must, I think, do the best it can on the material before it’.⁴⁹⁰ This seems contradictory if an obvious breach of duty is required.

Despite the rhetoric from the courts that a lack of sufficient merit does not mean the claim will be unsuccessful, the actual decisions suggest otherwise. In *Stainer* and *Parry v Bartlett* both cases were significantly strong, with *Parry* being noted as a case that would have been

⁴⁸⁸ *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) L.S.G. 19 at [42]

⁴⁸⁹ *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 at [36]

⁴⁹⁰ *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 at [79]

allowed under the old common law as well as the statutory procedure,⁴⁹¹ whilst in *Stainer* the court stated on a couple of occasions that the claims relating to the breaches of duty were “well arguable”.⁴⁹² *Kiani* also had a strong case since the other side failed to produce any evidence. Cases that have also not satisfied the court’s discretion or been barred have had sufficiently weak claims. *Seven Holdings*, *Iesini* and *Stimpson* all failed to establish any real strength to their claims. *Kleanthous* was also dismissed because the legal claims were of little strength and size.⁴⁹³ The decisions create the suggestion that the consideration under section 263(3)(b) is the most important to the judge’s discretion. This is supported by the fact that the benefit of the claim will be returned to the company and so if the claim is not for its benefit it should not be pursued. So if a hypothetical director would conclude that little weight would be attached to the claim then it is likely to be unsuccessful since there would be little benefit to the company.

It seems that the court have stopped short of saying that a weak legal claim will mean the court will not grant permission and other circumstances may justify permission being granted, but their attitude towards a claim that fails to demonstrate sufficient merit can be significantly harmful to the shareholder’s prospects for success since a hypothetical director that concludes little weight would be attached to the claim is unlikely to want to continue. This may hinder the objectives of the reform and pursuing a claim against a non-executive director. Whilst this thesis has shown that non-executives do owe fiduciary duties, what the scope of that duty is and applied it to multiple appointments, the fact the law is in some respects uncertain may mean that demonstrating a case has sufficient legal merit may be difficult for a shareholder to establish. Yet given the duty is “so well settled” it may be that demonstrating a breach against a non-executive may not be an unrealistic possibility.

⁴⁹¹ *Parry v Bartlett* [2011] EWHC 3146 (Ch) at [81]

⁴⁹² *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [42], [46]

⁴⁹³ *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) L.S.G. 19 at [85]

c. Availability of another remedy

The previous relationship between the unfair prejudice remedy and the derivative claim often meant that claimants would pursue the former. The continued relationship between the two can help evidence whether the availability of another remedy, when the court applies its discretion or otherwise, hinders the accessibility and use of the derivative claim procedure. If the availability of another remedy is still used favourably by shareholders then the prospect of the company enforcing breaches of fiduciary duties against non-executives may be small.

Initially the practical benefits of the unfair prejudice remedy may mean that it is still preferred where one is available before the shareholder even considers pursuing a derivative claim. The prospect of a personal remedy, not having to establish standing, as well as the potential costs involved in a derivative claim with the time spent in court, which to some extent have potentially been reduced but are still a deterrent to pursuing a claim,⁴⁹⁴ will mean the remedy is still preferred.

Where a derivative claim does commence and discretion is applied to the availability of another remedy under section 263(3)(f) the court appears to be heavily influenced by the remedy that is actually sought by the claimant and what the appropriate means of achieving it are. In *Stainer* the court considered that the theoretical availability of an unfair prejudice petition under the Companies Act 2006, s. 994 is not a reason to refuse permission. The court continued that the claimant was not seeking to be bought out, the remedy sought could not be obtained through section 994 and 35 other minority shareholders supported the claim for corporate relief.⁴⁹⁵ *Hughes v Weiss* also took the same stance to the theoretical

⁴⁹⁴ See, for example, *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 – took 4 days in court; *Kiani v Cooper* [2010] EWHC 577 (Ch); [2010] B.C.C. 463 – took 1 day in court

⁴⁹⁵ *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [52]

availability of another remedy. Here the remedy sought was financial for the company for misfeasance and she was not looking to be bought out⁴⁹⁶ and a claim brought by the liquidator or under section 994 would not be appropriate.⁴⁹⁷ In *Phillips v Fryer* the remedy sought there was to have the sums wrongfully taken from the company returned⁴⁹⁸ for which an unfair prejudice petition would not be capable of providing such a remedy.⁴⁹⁹ Both *Stainer* and *Hughes* cited the *dictum* from *Re Charnley Davies Ltd (No 2)* that established the point that the remedy sought must relate to the nature of the complaint:

The very same facts may well found either a derivative action or a s [994] petition. But that should not disguise the fact that the nature of the complaint and the appropriate relief is different in the two cases. Had the petitioners' true complaint been of the unlawfulness of the respondent's conduct, so that it would be met by an order for restitution, then a derivative action would have been appropriate and a s [994] petition would not. But that was not the true nature of the petitioners' complaint. They did not rely on the unlawfulness of the respondent's conduct to found their cause of action; and they would not have been content with an order that the respondent make restitution to the company. They relied on the respondent's unlawful conduct as evidence of the manner in which he had conducted the company's affairs for his own benefit and in disregard of their interests as minority shareholders; and they wanted to be bought out. They wanted relief from mismanagement, not a remedy for misconduct.⁵⁰⁰

Whilst the case makes it clear that a derivative claim can be pursued if it is the appropriate means of achieving the remedy sought even if a section 994 petition is theoretically

⁴⁹⁶ *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [66]

⁴⁹⁷ *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [68]-[69]

⁴⁹⁸ *Phillips v Fryer* [2012] EWHC 1611 (Ch); [2013] B.C.C. 176 at [18]

⁴⁹⁹ See, for example, *Kung v Kou* (2004) 7 HKCFAR 579; *Re Charnley Davies Ltd (No 2)* [1990] B.C.L.C. 760; cf. *Clark v Cutland* [2004] 1 W.L.R. 783; *Gamlestaden Fastigheter AB v Baltic Partners Ltd* [2007] UKPC 26; [2007] Bus. L.R. 1521 (PC (Jer))

⁵⁰⁰ *Re Charnley Davies Ltd (No 2)* [1990] B.C.L.C. 760, 784; cited by *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [66]; *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [51]

available,⁵⁰¹ this was the position pre-2006. Therefore the reform has not altered the law in this respect. As such a breach of fiduciary duty may still be remedied for a shareholder through a section 994 petition providing the petitioner's complaint is more than a complaint about the unlawful conduct but that the majority shareholder has 'conducted the company's affairs for his own benefit and in disregard of their interests as minority shareholders'.⁵⁰² Yet the recognition of the pre-existing law in this area will mean claims where the appropriate remedy sought is corporate relief, the fact there is a theoretical possibility of another remedy will not prevent the claim from continuing in the appropriate circumstances.

Whilst the theoretical possibility of another remedy would not result in a claim being dismissed if it is not appropriate, where there is an appropriate alternative remedy the court has found this to be a good reason to dismiss a claim. In *Kleanthous* the claimant had indicated a desire to be bought out, which is the usual remedy for a section 994 petition.⁵⁰³ In *Franbar* and *Bamford* there were also shareholder agreements that could rightfully be pursued to remedy the complaint made.⁵⁰⁴ Therefore the courts seem predisposed to dismiss a claim where a good reason presents itself to do so despite other circumstances. These cases seem to support the previous position taken in *Barrett v Duckett* that where another *adequate* remedy is available the court will not allow the claim to proceed.⁵⁰⁵ Whilst the availability of another remedy is clearly not a bar to a claim, it shows that where an adequate one is available, i.e. appropriate for what the claimant is trying to achieve, then the courts should use its discretion to refuse leave. As well none of the successful claims that

⁵⁰¹ See, *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 at [123]; *Barrett v Duckett* [1995] 1 B.C.L.C. 243; [1995] B.C.C. 362, 367

⁵⁰² *Re Charnley Davies Ltd (No 2)* [1990] B.C.L.C. 760, 784

⁵⁰³ Companies Act 2006, s. 996

⁵⁰⁴ *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 at [54]; *Bamford v Harvey* [2012] EWHC 2858 (Ch); [2013] Bus. L.R. 589 at [28]-[29]

⁵⁰⁵ *Barrett v Duckett* [1995] 1 B.C.L.C. 243; [1995] B.C.C. 362, 367

consider the availability of another remedy have failed to also demonstrate significant merit to their claim. Therefore at this point it cannot accurately be determined whether a court would allow a claim with weak legal merit where the appropriate remedy sought was corporate relief but at this point it seems unlikely. However, where there is a strong legal claim and adequate alternative remedy is available it seems likely that the courts would dismiss the claim. This is perhaps acknowledgement that the claim is one of last resort and the negative language used in section 263(3) as to what the court must consider at its discretion.⁵⁰⁶ Other examples for claims being dismissed have included the interests of the employees,⁵⁰⁷ avoidance of insolvency rules⁵⁰⁸ and an independent report in *Kleanthous*. The court's attitude and the implicit guidance in the statutory reform to find reasons to dismiss a claim since it is a last resort coupled with the difficulty a shareholder may face in demonstrating a sufficiently strong case may mean that whilst the claim is initially accessible the court is reluctant to allow claims to continue in appropriate circumstances at its discretion where a good reason is presented not to.

However, the likelihood that a claim will be dismissed where another adequate remedy is available may not hinder a claim against a non-executive director. This is because a claim against a non-executive is likely to be against a larger company containing a greater number of shareholders. Any self-interest by a non-executive causing loss to a shareholder is likely to be reflective meaning the appropriate remedy would be corporate relief.⁵⁰⁹ This may be more so in duty-duty conflicts where a third party's interests are preferred by the non-

⁵⁰⁶ J Lowry and A Reisberg, *Pettet's Company Law: Company and Capital Markets Law*, (3rd edn Pearson, 2009) 237

⁵⁰⁷ *Stimpson v Southern Landlords Association* [2009] EWHC 2072 (Ch); [2010] B.C.C. 387 at [37]; see also, D Gibbs, 'Has the statutory derivative claim fulfilled its objectives? The hypothetical director and CSR: Part 2' (2011) 32(3) *Company Lawyer* 76

⁵⁰⁸ *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch) at [22]

⁵⁰⁹ See, for example, *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch. 204

executive causing a diminution in value to all the shareholders collectively. Also in larger companies where there are more shareholders, the relationship between the wrongdoing directors and shareholders may be able to continue. In small companies the directors are also likely to be the shareholders. Where there is a disagreement between those parties the appropriate remedy is not likely to be corporate relief because of the breakdown in the relationship makes the company's continuation unfeasible. Therefore the adequate remedy in those situations is usually a purchasing order of the minority's shares provided there has been unfairly prejudicial conduct.⁵¹⁰ The post-2006 claims certainly demonstrates this so far where in *Kleanthous* the two shareholders owned 84.5% and 15.5% respectively and in *Franbar* the shareholders had a 75% to 25% split. In *Hughes* the claim was allowed despite there being equal ownership of 50%, but the circumstances showed a derivative claim was appropriate since the company itself was to be dissolved and so the relationship between the parties had been discontinued already. In these situations the continued relationship would not be appropriate. Comparing this with *Stainer* there were several shareholders in the company, with the claimant and respondent making up only 87.08% of share ownership. It was possible then for the relationship to continue with *Stainer* as a shareholder.

Since 2006 it seems whilst the court may consider all the relevant facts of the case in determining whether the cases is appropriate to continue in the circumstances, it is not so much about a balancing act between the relevant circumstances and more about convincing the court that the legal merits of the claim are strong and there is no good reason to dismiss the claim. The accessibility of a derivative action to enforce fiduciary duties against non-executives is still limited. The fact that the relationship between the unfair prejudice petition and the derivative claim remains unaltered means it is unlikely claimants will use the derivative claim instead of the unfair prejudice petition. However, it is noteworthy that in larger companies, where they are likely to have non-executives, a derivative claim may be

⁵¹⁰ Companies Act 2006, s. 966; see also, B Hannigan, *Company Law*, (2nd edn OUP, 2009) 413-5

the more appropriate remedy since the continued relationship between the shareholders in the company will still be possible and any loss by shareholders is likely to be reflective.

d. Wrongdoer Control

The pursuit of a breach of fiduciary duty against a non-executive under the common law may have been a difficult case to establish. The requirement that the wrongdoer be in control would mean a claim is barred if it is not demonstrated based on the principles of majority rule and the proper plaintiff. A wrongdoer in control is a person normally responsible for commencing litigation who has improperly declined to do so.⁵¹¹ If the company could rightfully take the decision to litigate then it should be left to do so. A claim against non-executives under the old law is unlikely due to this bar because they are unlikely to have sufficient voting power to exercise effective control.⁵¹² Only two cases had sought to enforce duties against non-executives prior to 2006 and those were unsuccessful.⁵¹³

The requirement that wrongdoers be in control has now been removed as a bar to bringing a claim. 'We made a conscious decision not to continue that as part of the derivative claim procedure.'⁵¹⁴ 'The common law requirement of "wrongdoer control", in particular, had given rise to difficulty in a number of cases ... and is not repeated.'⁵¹⁵ The Companies Act 2006, s. 261(2) recognises this removal by allowing "a shareholder" to bring a claim in respect of an action vested in the company. There is no prerequisite to shareholdings or control of

⁵¹¹ B Black *et al*, 'Legal Liability of Directors and Company Officials Part 2: Grounds for Liability' (Report to the Russian Securities Agency) (2007) 3 *Columbia Business Law Review* 26

⁵¹² B Cheffins and B Black, 'Outside Director Liability Across Countries' (2006) 84 *Texas Law Review* 1385, 1405

⁵¹³ *Equitable Life Assurance Society v Bowley* [2003] EWHC 2263 (Comm); [2003] B.C.C. 829; *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch. 204

⁵¹⁴ Hansard HL Vol 681, Official Report, 9/5/2006, col 888

⁵¹⁵ *Wishart v Castlecroft Securities Ltd* [2009] CSIH 65; [2010] B.C.C. 161 at [38]; approved in *Bamford v Harvey* [2012] EWHC 2858 (Ch); [2013] Bus. L.R. 589 at [29]

claimants or respondents. Reasons behind its removal are likely to be based on policy since the fundamental principles were leading to inequitable results that the common law could not rectify, where unlawful activity may have been clear yet wrongdoer control was too difficult to establish and this gave too much power in the relationship to the majority.

Subsequently non-executives are more capable of being pursued for a breach of duty since they do not have to be in control of the litigation decision. As Lord Reed observed: 'nor...can we endorse a rule that leave can only be granted where the directors whose breach of duty is in issue were and remain in majority control'.⁵¹⁶ One claim has been pursued against the non-executives in *Mission Capital*, although in this case all three non-executives were wrongdoers in a 3v2 majority on the board meaning they were in fact in control. Yet it does go to show that non-executives can be pursued through this means to deter them from breaching their duty against the interests of the company serving as a possible means of *ex post* control.

Whilst wrongdoer control has been removed, the Commission were clear that the principles of majority rule and proper plaintiff were 'fundamental to any rational system of jurisprudence'.⁵¹⁷ From the cases heard under the new procedure it is clear that these principles are still part of the court's discretion in granting leave. *Bamford* has recognised that the proper plaintiff principle is something the court can consider at its discretion but is not something that should bar a claim. Roth J held:

I accept that "wrongdoer control" is not an absolute condition for a derivative claim: if it were, it would be specified as such in s. 263(2) ... But I do not see anything in the opinion in

⁵¹⁶ *Wishart v Castlecroft Securities Ltd* [2009] CSIH 65; [2010] B.C.C. 161 at [38]

⁵¹⁷ Law Commission Report, para 6.93

Wishart to suggest that the potential for the Company itself to commence proceedings is not a relevant consideration in the exercise of the court's discretion.⁵¹⁸

Therefore, like the legal merits assessment being removed for fraud on the minority/breach of duty but technically reintroduced by the requirement to assess the claim as a hypothetical director, the same seems to have occurred for wrongdoer control. Introducing the principle of proper plaintiff back in to the court's discretion at the second stage may mean the removal of wrongdoer control as a bar, which would allow a claim against non-executives to be pursued, may be instantly reversed if the court considers this to be a significant consideration, which advocates spend significant time debating at the permission stage, once again increasing the cost and time on a preliminary issue. However, giving the discretion to the court on the issue to consider all relevant circumstances will allow it to assess whether it is a reason to dismiss a claim but not a bar if it does not have to meet a certain threshold.⁵¹⁹

The approach so far seems to be that where the company could pursue the claim and there is nothing to suggest otherwise why they should not, this factor would be significant in counting against giving permission because the company would be the proper plaintiff. However, where there is evidence that the proper plaintiff principle may be being abused in some manner by the wrongdoer then it is unlikely to count against the claimant. This individual consideration will then be considered against any other relevant circumstances in granting permission. This approach can be observed from the contrasting decisions of *Kleanthous* and *Stainer*. Although these two cases do not explicitly refer to the principles they do so implicitly in how they respect the wishes of the company. In *Kleanthous* the court

⁵¹⁸ *Bamford v Harvey* [2012] EWHC 2858 (Ch); [2013] Bus. L.R. 589 at [29]

⁵¹⁹ *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [29]; *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) L.S.G. 19 at [40]; *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [33]

considered the views from disinterested shareholders⁵²⁰ and from an independent report⁵²¹ conducted as to whether there was any illegal activity and whether litigation should be commenced. It was debated whether the report was truly independent since it was authorised by the wrongdoers to conduct the review but the court at its discretion considered the views from the independent report a significant factor as to whether leave should be granted. However, in *Stainer v Lee* whilst the disinterested shareholders may have approved of a loan complained about by the minority shareholder, the court considered authorisation unlikely since the evidence before it demonstrated that the disinterested shareholders were likely to have been deceived in approving the loan.⁵²² Even if the approval of the loan amounted to authorisation, the fact the shareholders were deceived would have been unlawful authorisation since it was brought about by improper means.⁵²³ These two cases, as well as *Bamford*, show that proper plaintiff and majority rule are simply circumstances the court will consider at its discretion if the facts reveal them to be relevant.⁵²⁴ Upon the facts before the court it considers whether the company is being improperly prevented from enforcing its rights but does not need to determine to a sufficient threshold, as it did under the common law, if the company actually is the proper plaintiff in its own right, which came at considerable time and expense.

⁵²⁰ *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) L.S.G. 19 at [82]-[83]

⁵²¹ *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) L.S.G. 19 at [74]-[75]; see also, *Smith v Croft (No 2)* [1988] Ch. 114, 185

⁵²² *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] B.C.C. 134 at [46]

⁵²³ *North-West Transportation v Beatty* (1887) 12 App. Cas. 589; see also, *Kaye v Croydon Tramways Co* [1898] 1 Ch. 358

⁵²⁴ Which they have been explicitly in *Bamford v Harvey* [2012] EWHC 2858 (Ch); [2013] Bus. L.R. 589; *Wishart v Castlecroft Securities Ltd* [2009] CSIH 65; [2010] B.C.C. 161; and *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch)

The removal of wrongdoer control is not a complete disregard of the fundamental principles of company law. To maintain majority rule and proper plaintiff the court has put a number of safeguards in place – such as barring a claim if the actions or omissions have been ratified or authorised by the remaining unconnected majority;⁵²⁵ and if not the court at its discretion may consider whether the actions or omissions could be ratified or authorised;⁵²⁶ whether the company has decided not to pursue the claim;⁵²⁷ and the views of any disinterested members⁵²⁸ - in the procedure to ensure the court maintains the wishes of the majority where appropriate but where the court at its discretion feels the principle is being unfairly taken advantage of they may allow claims to continue.

This means that the removal of wrongdoer control makes enforcement of duties against non-executives theoretically more accessible. The principles will only be part of the court's discretion and where there is evidence that these principles are being abused this may count against the wrongdoer. It will not however, result in a detailed consideration of whether or not the company is in fact the proper claimant in its own right. The removal of wrongdoer control being necessary should go some way to making the derivative claim a useful *ex post* means of control. Despite this theoretical possibility of derivative enforcement against a non-executive director the reform did not wish to remove this fundamental principle and the case law under the new procedure confirms that where the company is the proper plaintiff this will be considered at its discretion as to whether to allow a claim. Since an individual non-executive is unlikely to be in control, unless there has been some abuse of the proper plaintiff principle the court is unlikely to grant leave. As noted in the introduction of this chapter, whilst the company may then enforce against the non-executive itself, there may be

⁵²⁵ Companies Act 2006, s. 263(2)(b)-(c); for ratification see Companies Act 2006, s.239

⁵²⁶ Companies Act 2006, s. 263(3)(c)

⁵²⁷ Companies Act 2006, s. 263(3)(e)

⁵²⁸ Companies Act 2006, s. 263(4)

several psychological factors that prevent this. Therefore the fact the reform has removed wrongdoer control making it possible for courts to grant leave against non-executives at its discretion, such permission is unlikely unless there has been an abuse of the proper plaintiff principle. It is thought that whilst the removal may have indicated the derivative claim as a useful means of *ex post* control, in practice it is unlikely to be as beneficial as initially thought. Yet where there has been an abuse of the principle the fact the claim does not have to demonstrate wrongdoer control will mean the procedure is capable of allowing claims to proceed in appropriate circumstances.

V. IS THE CLAIM A SUITABLE MEANS OF ENFORCEMENT FOR BREACH OF FIDUCIARY DUTY?

From the evidence produced the idea behind reform was to make the claim more accessible so claims could continue in appropriate circumstances. What is an appropriate circumstance according to the court appears to be a situation where there is no good reason to dismiss a claim and the claim shows sufficient legal merit. The removal of concepts such as wrongdoer control and fraud on the minority mean claims that relate to a breach of duty that are sufficiently strong and the claim does not demonstrate a good reason to be dismissed the claim will be able to continue without hindrance from any difficult terminology. The fact 35.7% of cases have so far been successful shows that to some extent claims are being allowed to continue in appropriate circumstances.

Despite the claim being made more accessible in appropriate circumstances there still seems to be a number of obstacles to continuing a derivative claim especially if one is pursued against a non-executive director. Initially the fact the claim is available to any shareholder for a breach of duty by a director in respect of an action vested in the company means the removal of wrongdoer control has allowed minorities to pursue a claim against non-executives, whereas before this would not have been likely as non-executives were not

in control. As well, the maintaining of the law relating to unfair prejudice petitions means that a claim against a non-executive will benefit from the fact the remedy sought is likely to most appropriately achieved through a derivative claim. The size of the company and the remedy sought are unlikely to make an unfair prejudice petition appropriate.

Whilst the means are there to pursue a derivative action against a non-executive it seems a number of factors will make the grant of leave from the court unlikely. The court's emphasis that a strong legal claim is needed may mean passing the mandatory bar and in particular the court's discretion is difficult. Whilst the reform wished to remove any threshold or merits test it seems where the court is faced with a good reason to dismiss such as a weak legal claim that lacks sufficient merit then they will do so. Demonstrating a significantly strong claim against a non-executive may be particularly difficult for practical reasons such as information asymmetries as well as legal reasons that the law does not, in its current state, fully understand fiduciary duties as applicable to non-executives, nor how they operate for directors when owing duties to multiple principals, although some confusion may be off-set by the fact the duty is seen, generally, as "so well settled". Even then, if the claim does show significant merit the claim must avoid any other reason why the court should dismiss the claim. The transparency of the reasons why a claim may be refused in the legislation⁵²⁹ and the fact the courts seem willing to dismiss a claim if they are satisfied by one good reason to dismiss means the claim is not more accessible by giving the court discretion.

Notably the removal of wrongdoer control that makes a claim against a non-executive accessible in appropriate circumstances, that increased accessibility is reduced by the fact the proper plaintiff principle still forms part of the court's discretion. Where the court is satisfied there has been no abuse of the principle it is likely to dismiss the claim. This is

⁵²⁹ See, J Lowry and A Reisberg, *Pettet's Company Law: Company and Capital Markets Law* (3rd edn Pearson, London 2009) 237

perhaps for good reason that the principle is one that forms any rational system of jurisprudence. Yet it means that the shareholder with the wherewithal to enforce the company's rights against a non-executive may be prevented by directors who have psychological incentives not to enforce against one of their own, or by shareholders who out of apathy, or other reasons, have decided not to take action. However, the fact that wrongdoer control does not have to be proved on a *prima facie* basis means that if the claimant produces evidence that the proper plaintiff principle may have been abused then the court can consider this at its discretion when granting leave. Yet, this itself may be difficult given informational asymmetries and the fact the board may withhold evidence as in *Kiani and Franbar*.

Therefore, the derivative claim can rightfully be described, in some respects, as more accessible, but in respect of a claim against non-executive directors for breach of loyalty claims of such type will be rare, at least those that will be granted permission. The derivative claim in its current state means it is unlikely to act as a legal deterrent against non-executives for breach of fiduciary duty and they are not faced with effective *ex post* control to prefer their principal's interests. Non-executives may continue to view multiple appointments as a form of perquisite consumption against the interests of the principal, which may lead to bad corporate governance as Zhang hypothesised. Whilst non-executives may be removed by ordinary resolution they are unlikely to be made legally responsible for a breach of their duty of loyalty. It is perhaps inaccurate to refer to it still as a weapon of last resort,⁵³⁰ since derivative claims are being permitted despite the availability of an unfair prejudice petition, although where the petition is more appropriate the courts are not likely to grant leave. However the derivative claim is certainly not a race to the courthouse as described in the US.⁵³¹ Given that legal enforcement through a derivative claim is generally inadequate as a

⁵³⁰ Hansard HL Vol 679, Official Report, 27/2/06 Col GC4

⁵³¹ D Branson, *Corporate Governance* (Michie, Charlottesville, Virginia 1993) 591

means of controlling non-executives *ex post* from breaching their fiduciary duties, which may lead to bad governance, other means of aligning the non-executives' interests need to be analysed to ensure they act for the principal's interests and provide good governance.

Chapter V

Corporate Governance Theories: ex ante means to align non-executive interests

Corporate law typically vests principal authority over corporate affairs in a board of directors... business corporations are distinguished by a governance structure in which all but the most fundamental decisions are delegated to the board of directors.⁵³²

The continuance of willingness... depends upon the satisfactions that are secured by individual contributors in the process of carrying out the purpose. If the satisfactions do not exceed the sacrifices required, willingness disappears, and the condition is one of organization inefficiency.⁵³³

I. EX ANTE INCENTIVES

The duty to avoid conflicts of interest is a proscription that allows the principal to assess the agent's work and, if necessary, enforce the duty *ex post*. Once a breach occurs the principal has to decide whether to enforce that duty against the agent. The weakness in the enforcement mechanism means it becomes more important to have appropriate governance structures within the company that can incentivise *ex ante* what fiduciary duties enforce *ex post*. Good governance may minimise the risk of non-executives taking on too many additional appointments and acting against the principal in those appointments out of self-interest. This chapter aims to explore the various theoretical underpinnings of a good corporate governance structure that seek to maximise the chance that the director acts for the benefit of the company. In this thesis the terms "good" or "optimum" governance structures are referred to in the context of how to minimise the risk of self-interest and align interests. It does not necessarily imply that good governance will result in better firm

⁵³² J Armour, H Hansmann and R Kraakman, 'What is Corporate Law?', in R Kraakman et al (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach*, (2nd edn OUP, 2009) 13

⁵³³ C Barnard, *The Functions of the Executive*, (Harvard University Press, 1964) 82

performance. Although theory may imply that it does⁵³⁴ and some empirical literature supports this,⁵³⁵ firm performance is only an incidental point and not the main focus of this chapter or the next.

This chapter shall begin a review of some prominent theories on how corporate governance structures can be designed so a director acts for the benefit of the firm in multiple appointments. It will also discuss some of the relevant benefits and detriments of multiple appointments can have on the governance of an individual firm. This insight will provide for the review on the theoretical approaches⁵³⁶ on how the interests of conflicting parties can be brought in to alignment. This thesis will be looking at agency theory,⁵³⁷ stewardship theory⁵³⁸

⁵³⁴ See, for example, E Fama and M Jensen, 'Separation of Ownership and Control' (1983) 26(2) *Journal of Law and Economics* 301; A Hillman and T Dalzell, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383 cf. J Armour, S Deakin and S Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41(3) *British Journal of Industrial Relations* 531

⁵³⁵ See, for example, G Tain and G Twite, 'Corporate governance, external market discipline and firm productivity' (2011) 17(3) *Journal of Corporate Finance* 403; B Baysinger and H Butler, 'Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition' (1985) 1(1) *Journal of Law, Economics and Organization* 101; G Nicholson and G Kiel, 'Can Directors Impact Performance? A case-based test of three theories of corporate governance' (2007) 15(4) *Corporate Governance: An International Review* 585; N Brennan, 'Boards of Directors and Firm Performance: is there an expectation gap?' (2006) 14(6) *Corporate Governance: An International Review* 577; C Ingley and N van der Walt, 'Do Board Processes Influence Director and Board Performance' (2005) 13(5) *Corporate Governance: An International Review* 632 cf. C Weir and D Laing, 'Governance structures, director independence and corporate performance in the UK' (2001) 13(2) *European Business Review* 86

⁵³⁶ See, L Van den Berghe and A Levrau, 'Evaluating Boards of Directors: what constitutes a good corporate board?' (2004) 12(4) *Corporate Governance: An International Review* 461, 470

⁵³⁷ M Jensen and W Meckling, 'Theory of the Firm: Managerial behaviour, agency costs and ownership structures' (1976) 3(4) *Journal of Financial Economics* 305; K Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14(1) *Academy of Management Review* 57

and resource dependence theory.⁵³⁹ How a company structures its internal governance may be influenced by theory on what will incentivise its directors to act for its benefit. The theories of agency and stewardship view the individual as a utility maximizer.⁵⁴⁰ They attempt to design structures to ensure the individual is motivated to align his or her interests by providing a structure that allows the individual to maximise their own utility.⁵⁴¹ Applying the right incentives through the governance of the company can ensure the individual takes and uses additional appointments for the benefit of the company because it will maximise their own utility. Inadequate incentives can mean the individual is not incentivised and takes additional appointments for their own perquisite consumption.⁵⁴² Resource dependence however focuses on the ability of the individual to provide resources to the firm. This theory primarily perceives that those with more resources will perform better in their role. One particular resource or indicator of value of a director is the amount of directorships they hold.⁵⁴³ This is of particular importance in ensuring the individual is motivated to provide

⁵³⁸ See, for example, J Davis, F Schoorman and L Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22(1) *Academy of Management Review* 20; G Nicholson and G Kiel, 'Can Directors Impact Performance? A case-based test of three theories of corporate governance' (2007) 15(4) *Corporate Governance: An International Review* 585; J Roberts *et al*, 'Beyond Agency Conceptions of the Work of the Non-Executive Director' (2005) 16 *British Journal of Management* 5

⁵³⁹ See, for example, A Hillman and T Dalzell, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383

⁵⁴⁰ M Jensen and W Meckling, 'Theory of the Firm: Managerial behaviour, agency costs and ownership structures' (1976) 3(4) *Journal of Financial Economics* 305; J Davis, F Schoorman and L Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22(1) *Academy of Management Review* 20, 24

⁵⁴¹ See, for example, J Davis, F Schoorman and L Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22(1) *Academy of Management Review* 20, 22, 24

⁵⁴² S Ferris, M Jagannathan and A Pritchard, 'Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments' (2003) 58(3) *The Journal of Finance* 1087, 1097

⁵⁴³ E Fama and M Jensen, 'Separation of Ownership and Control' (1983) 26(2) *Journal of Law and Economics*

resources to the firm under resource dependence theory. Since agency and stewardship provide mirroring opinions on how to motivate an agent the interplay between what motivates an individual and their ability to provide resources is critical. Therefore the theories of agency-resource dependence and stewardship-resource dependence will be made reference to at certain points to establish how boards should be structured to motivate directors to apply and obtain resources for the benefit of the company.

The purpose of this review is not to try to identify the best conditions for incentivising non-executives to act for the benefit of the firm. It is considered that individuals do not all fit in to the same theoretical model and may react differently to certain incentives due to any number of variables. As well, the perspectives of agency and stewardship which perceive the individual as a utility maximiser, and resource dependence that theorises the individual who is best for the task is the one with the most resources may mean there are potential trade-offs between incentives and resources. The remainder of this chapter is going to focus on the risks that a particular governance structure may pose, according to each individual theory, to incentivising the individual. Each theory perceives different models as optimum but as boards vary, firms must account for the different aspects within their firm. Therefore this chapter aims to identify the effects multiple appointments can have on the governance of the company; different theories behind incentivising individuals; and how the theories perceive the potential risk to the governance of the company according to the remaining theories.

II. MULTIPLE DIRECTORSHIPS AND CORPORATE GOVERNANCE

When a non-executive holds multiple appointments it is possible that they are incentivised to prefer one firm to another. This may lead to two distinct problems of the individual preferring the interests of one firm but also failing to provide appropriate governance in all the firms they hold directorships on. Evidence from economics and finance literature has provided an insight as to the effects multiple directorships can have on the governance of a firm.

As Fama and Jensen theorised, holding additional appointments is a signal of worth in the managerial labour market.⁵⁴⁴ This theory was supported by Ferris' *et al* study that found firm past performance correlates with amount of directorships subsequently held by the directors and non-executives with additional appointments attended more meetings.⁵⁴⁵ Masulis and Mobbs have also found that non-executives with additional appointments can be valuable to a firm as it means they will be less dependent on the CEO.⁵⁴⁶ An often cited benefit of additional appointments is the access to additional resources they provide. Hillman and Dalziel argue they 'help reduce dependency between the organization and external contingencies, diminish uncertainty for the firm, lower transaction costs, and ultimately aid the survival of the firm'.⁵⁴⁷ Westphal opined that closer social ties and networks between the CEO and outside directors can increase the frequency of advice and counsel interactions.⁵⁴⁸ According to Eisenhardt and Schoonhoven this increase in access to resources, information and opportunities may also be particularly useful in difficult market conditions, such as a recession, entering a new market or a heavily populated one.⁵⁴⁹

⁵⁴⁴ E Fama and M Jensen, 'Separation of Ownership and Control' (1983) 26(2) *Journal of Law and Economics* 301, 315

⁵⁴⁵ S Ferris, M Jagannathan and A Pritchard, 'Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments' (2003) 58(3) *The Journal of Finance* 1087

⁵⁴⁶ R Masulis and S Mobbs, 'Are all Inside Directors the Same? Evidence from the External Directorship Market' (2011) 66(3) *The Journal of Finance* 823

⁵⁴⁷ A Hillman and T Dalziel, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383, 386

⁵⁴⁸ J Westphal, 'Collaboration in the Boardroom: Behavioural and Performance Consequences of CEO-Board Social Ties' (1999) 42(1) *The Academy of Management Journal* 7

⁵⁴⁹ K Eisenhardt and C Schoonhoven, 'Resource-Based View of Strategic Alliance Formation: Strategic and Social Effects in Entrepreneurial Firms' (1996) 7(2) *Organization Science* 136

Despite these potential benefits, other literature demonstrates there may be a trade-off, whilst some has found contrary evidence to that above. Therefore the effects of multiple appointments are somewhat inconclusive.

Ferris *et al* showed that whilst in some respects those with more appointments may be better monitors, a board with more appointments would have an above average board size,⁵⁵⁰ have less independent representation, owned less equity in the firm and the directors viewed additional appointments as perquisite consumption. They theorised that holding less equity would mean they could take more appointments at lower personal cost to themselves.⁵⁵¹ Yet, Renneboog and Zhao's research found non-executive shareholders are not more effective monitors.⁵⁵² They found non-executives with higher ownership did not reduce CEO compensation. This may be because the non-executive has become too dependent on the firm. This is similar to Masulis and Mobbs' study that identified non-executive with more external appointments were less dependent on the firm and thus better monitors. Research conducted by Bebchuk and Fried⁵⁵³ also suggests the role of the managerial labour market is over-emphasised in regards to board appointments. They argue that a powerful CEO can exert significant control over the board and therefore boards are unlikely to appoint somebody whom the CEO disapproves of. The position of a non-executive is lucrative, and if

⁵⁵⁰ See, for example, Grant Thornton Corporate Governance Review, 'A Changing Landscape: Are you ready?' (2010) <http://www.grant-thornton.co.uk/thinking_blogs/publications/corporate_governance_review.aspx> accessed 14th Mar 2011; and Grant Thornton Corporate Governance Review, 'Moving Beyond Compliance: Embracing the spirit of the code' (2009) <http://www.grant-thornton.co.uk/thinking_blogs/publications/corporate_governance_review_-2.aspx> accessed 14th Mar 2011

⁵⁵¹ S Ferris, M Jagannathan and A Pritchard, 'Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments' (2003) 58(3) *The Journal of Finance* 1087

⁵⁵² L Renneboog and Y Zhao, 'Us knows us in the UK: On director networks and CEO compensation' (2011) 17(4) *Journal of Corporate Finance* 1132, 1150

⁵⁵³ L Bebchuk and J Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, (Harvard University Press, 2006)

that position depends on the support of the CEO, non-executives may become unwilling to challenge their decisions. This is supported by empirical research conducted by Qi that finds it is the director's existing networks and social ties that determine board appointments.⁵⁵⁴ Also, Renneboog and Zhao⁵⁵⁵ studied the effect of CEO compensation on networks to find that more extensive networks lead to the CEO obtaining higher compensation that is also less performance sensitive, suggesting these "busy" boards may not be effective monitors. Fich and Shivdasani⁵⁵⁶ found that directors with more appointments have an increased likelihood of departing an under-performing firm. Thus, whilst a director may be brought in to assist in difficult market conditions due to their access or connections they may not stay if the firm under performs. Other qualitative studies have also shown negative perceptions of additional appointments held by directors that in taking them on they may not have sufficient time for discharge of one's duties.⁵⁵⁷

From the economics and finance literature it is observed that there are at least trade-offs when permitting multiple directorships. Whilst allowing for multiple directorships may bring about better governance, firms have to be careful the directors do not take on too many to the ultimate detriment of the firm. How theory predicts individuals may be incentivised through corporate governance structures shall now be considered.

⁵⁵⁴ Qianru Qi, 'How Does the Director's Social Network Matter? Evidence From Structure Estimation' (2010) <<http://ssrn.com/abstract=1786555>> accessed 14th April 2011

⁵⁵⁵ L Renneboog and Y Zhao, 'Us knows us in the UK: On director networks and CEO compensation' (2011) 17(4) *Journal of Corporate Finance* 1132

⁵⁵⁶ E Fich and A Shivdasani, 'Are Busy Boards Effective Monitors?' (2006) 61(2) *The Journal of Finance* 689

⁵⁵⁷ M Lipton and J Lorsch, 'A modest proposal for improved corporate governance' (1992) 48 *Business Lawyer* 59; Korn/Ferry International, '30th Annual Board of Directors Study' 2003 <http://www.kornferryinstitute.com/about_us/thought_leadership_library/publication/1492/30th_Annual_Board_of_Directors_Study> accessed 15th April 2011

III. THEORIES ON GOVERNANCE STRUCTURES

a. Agency theory

Jensen and Meckling first theorised about an agency problem⁵⁵⁸ in firms based on Berle and Means' study⁵⁵⁹ that evidenced a division of ownership and control within the firm. They acknowledged that where an individual has a conflict between their own and another's interests they will inherently favour their own. Agency theory seeks to explain how 'conflicting objectives of the individual parties are brought into equilibrium'.⁵⁶⁰ This theory supposes that due to the separation a principal needs to incur "agency costs" to help align the agent's interests with their own and prevent shirking. Jensen and Meckling define agency costs as: (1) monitoring of the agent; (2) bonding expenditure; and (3) residual loss.⁵⁶¹ This will restrict an agent, as a utility maximizer, from preferring their own personal interests by making the parties' interests synonymous.

Agency theory itself is an economic model of corporate governance. The analysis is based on rational actors and efficient markets.⁵⁶² On this presumption it theorises that where it is more beneficial to prefer your own interests to your principal's then a rational actor would chose to do so. Agency theory bases whether it is more beneficial to prefer your own interests on financial reward. From this there are two points of view: the agent's view and the

⁵⁵⁸ M Jensen and W Meckling, 'Theory of the Firm: Managerial behaviour, agency costs and ownership structures' (1976) 3(4) *Journal of Financial Economics* 305

⁵⁵⁹ A Berle and G Means, *The Modern Corporation and Private Property*, (MacMillan, London 1932)

⁵⁶⁰ M Jensen and W Meckling, 'Theory of the Firm: Managerial behaviour, agency costs and ownership structures' (1976) 3(4) *Journal of Financial Economics* 305, 307

⁵⁶¹ M Jensen and W Meckling, 'Theory of the Firm: Managerial behaviour, agency costs and ownership structures' (1976) 3(4) *Journal of Financial Economics* 305 at 308

⁵⁶² Although it is often argued that market prices follow a "random walk" see, for example, R Brealey, S Myers and F Allen, *Principles of Corporate Finance: Global Edition* (10th edn, McGraw Hill 2011) 342; citing M Kendall, 'The Analysis of Economic Time Series: Part 1 – Prices' (1953) *Journal of the Royal Statistical Society* 96

principal's view. Ultimately the principal is the one who bears the agency costs. Theoretically, a principal is only going to create agency costs if it is beneficial for him to do so. For example, if the cost of monitoring or enforcing certain behaviour is more than company value it is not efficient for the principal to create the agency cost. Jensen and Meckling demonstrate that as a principal's ownership levels decrease, agency costs will rise because there is an increase in the division ownership and control.⁵⁶³ This is supported by Deakin and Hughes' research, which showed that where the board owned a significant portion (50%+) of the shares there were no non-executive directors.⁵⁶⁴ From the agent's perspective those agency costs must be enough to incentivise them to prefer the principal's interests. If the financial reward of preferring one's own interests is greater than preferring the principal's, the agent will not act for the benefit of the principal. Therefore a non-executive seeking to act for another principal will make a rational decision. Agency costs must be incurred so that the decision is taken for the interests of the company.

Eisenhardt establishes that agency theory will be most relevant in three situations: (a) where there is substantial goal conflict that will allow for agent opportunism; (b) where there are high-levels of outcome uncertainty; and (c) where evaluating or monitoring performance can be difficult.⁵⁶⁵ Such situations are clearly present with a non-executive director and the company. For example, the non-executive is appointed to monitor and engage with strategy but close connections with the executive management and dependence on them for re-

⁵⁶³ M Jensen and W Meckling, 'Theory of the Firm: Managerial behaviour, agency costs and ownership structures' (1976) 3(4) *Journal of Financial Economics* 305, 308, 316

⁵⁶⁴ S Deakin and A Hughes, *ESRC Report* (ESRC Centre for Business Research, University of Cambridge 1999) para 4.2; cf. Grant Thornton Corporate Governance Review, 'A Changing Climate: Fresh challenges ahead?' (2011) <<http://www.grant-thornton.co.uk/en/Publications/2011/Corporate-Governance-Review-2011/>> accessed 25th Sep 2012

⁵⁶⁵ K Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14(1) *Academy of Management Review* 57, 71

election are just some examples of what may create goal conflict.⁵⁶⁶ Therefore the company will incur agency costs to align the interests of the parties. Countering the incentive problem, or how to counter an agent's self-interest, is central to the agency debate. Some have seen this as a narrow approach in an attempt to understand the organisation, such as Perrow who saw agency theory as narrow, dangerous containing no real problem, with scholars interpreting results to match their model of agency.⁵⁶⁷ Yet research clearly demonstrates the importance of agency in our understanding of the firm.⁵⁶⁸ Ultimately, agency theory has developed to establish evidence on optimum corporate governance mechanisms through reward and monitoring.⁵⁶⁹ According to agency theorists, this will help align interests and improve firm performance.⁵⁷⁰

⁵⁶⁶ See, L Bebchuk and J Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, (Harvard University Press, 2006)

⁵⁶⁷ C Perrow, *Complex Organizations: A critical essay* (3rd edn, McGraw Hill 1986) 224, 23; see also, P Hirsch, S Michaels and R Friedman, "Dirty Hands" versus "Clean Models": Is Sociology in Danger of Being Seduced by Economics?' (1987) 16(3) *Theory and Society* 317 – saw the theory and even economics itself as dominated by concerns of stock prices and one view of human nature, self-interest; K Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14(1) *Academy of Management Review* 57 – for an overview of agency theory

⁵⁶⁸ See, K Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14(1) *Academy of Management Review* 57 – for an overview of agency theory

⁵⁶⁹ M Jensen and W Meckling, 'Theory of the Firm: Managerial behaviour, agency costs and ownership structures' (1976) 3(4) *Journal of Financial Economics* 305, 308; E Fama and M Jensen, 'Separation of Ownership and Control' (1983) 26(2) *Journal of Law and Economics* 301

⁵⁷⁰ See, for example, E Fama, 'Agency Problems and the Theory of the Firm' (1980) 88(2) *Journal of Political Economy* 288; G Tain and G Twite, 'Corporate governance, external market discipline and firm productivity' (2011) 17(3) *Journal of Corporate Finance* 403; S Zahra and J Pearce, 'Boards of Directors and Corporate Financial Performance: A review and integrative model' (1989) 15(2) *Journal of Management* 291

Eisenhardt provides a detailed analysis of agency theory. According to Eisenhardt agency theory has two streams: Principal-agent research and positivist.⁵⁷¹ Principal-agent research identifies two potential types of contracts that seek to align interests: outcome-based contracts or behaviour-orientated contracts. The most efficient contract would be dependent on different aspects pertaining to the firm.⁵⁷² For example, the analysis demonstrates that where there are strong information systems,⁵⁷³ behaviour-orientated contracts should be preferred. Here the principal is more attuned to what the agents are doing and the agent recognises a reduced opportunity to deceive. Conversely, where information systems are bad, outcome-based contracts should be preferred as it is difficult to assess the agent's work, especially where there is a team effort or results may be attributed to luck.⁵⁷⁴ The most efficient contract will supposedly maximise the alignment of the parties' interests. Deciding on the most efficient contract can be difficult since the principal and agent may show different characteristics suited to the opposing contractual types. Mixed contracts and incentives can be formed with the agent to counter this problem.

Eisenhardt also acknowledges how positivist agency theory looks at the firm. She asserts this line of agency theory looks more at specific situations of conflict and the governance mechanisms designed to counter them i.e. boards of directors, compensation or managers owning equity in the firm. Fama provides one of the influential pieces on how compensation

⁵⁷¹ K Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14(1) *Academy of Management Review* 57, 59

⁵⁷² K Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14(1) *Academy of Management Review* 57, 70 – some of these aspects included: information systems i.e. labour and capital markets or board of directors; goal conflict; outcome uncertainty; outcome measurability; length of relationship; and task programmability

⁵⁷³ E Fama, 'Agency Problems and the Theory of the Firm' (1980) 88(2) *Journal of Political Economy* 288

⁵⁷⁴ K Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14(1) *Academy of Management Review* 57, 61

can counter the incentive problem in an agency relationship. He argues that the “wage revision process” will assist in countering the problem. The firm and its processes will be disciplined by competition from others, which will drive the evolution of efficient monitoring of performance. Fama identifies that if a manager’s wage is determined *ex ante*, what is to stop him shirking or consuming more perquisites during his period as manager. Through a wage revision process this counter-balances the agent’s desire to deviate from the *ex ante* contract where the weight of the process ‘is at least equivalent to full *ex post* settling up’.⁵⁷⁵ Performance-related pay (PRP) and equity have both become a prominent means of *ex post* remuneration. Empirical evidence has found directors’ interests are aligned with shareholders’ when given equity-based compensation,⁵⁷⁶ whereas fixed fees have been associated with dependence on firms and a lack of control.⁵⁷⁷ Many firms adopt high levels of PRP as agency theory dictates it will reduce conflict, where there are monitoring issues and outcome uncertainty. PRP is now prescribed by the Code to form a significant proportion of executive remuneration⁵⁷⁸ but non-executives are still primarily paid in fixed fees.

As well as providing incentives agency theory also predicts that there needs to be effective monitoring of the agent. Fama argues that the monitoring process is unlikely to come from those who they perceive to be the principal. Security owners, generally, have a diverse portfolio; a method deployed to spread risk. Thus security owners may have little interest in overseeing one particular firm. Ability to monitor can also be a problem for security holders. There can often be informational asymmetries between them and co-ordinating efforts can

⁵⁷⁵ E Fama, ‘Agency Problems and the Theory of the Firm’ (1980) 88(2) *Journal of Political Economy* 288, 306

⁵⁷⁶ See, for example, E Fich and A Shivdasani, ‘The Impact of Stock-Option Compensation for Outside Directors on Firm Value’ (2005) 78(6) *Journal of Business* 2229; G Tain and G Twite, ‘Corporate governance, external market discipline and firm productivity’ (2011) 17(3) *Journal of Corporate Finance* 403

⁵⁷⁷ A Hillman and T Dalzell, ‘Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives’ (2003) 28(3) *The Academy of Management Review* 383, 390

⁵⁷⁸ UK Corporate Governance Code 2010, Section D.1

be difficult even if there is the willingness to monitor.⁵⁷⁹ He acknowledges that managers themselves may be a good option. They will be in the “line of fire” if the markets for securities⁵⁸⁰ and managerial labour give poor signals about performance of the firm. Managers will also compete for top places and their wages are most likely to be affected by the signals from the markets.⁵⁸¹ However, the ability of market forces to align interests has been doubted. Bebchuk and Fried for example, highlight market forces cannot curb “significant redistributive actions”.⁵⁸² Also, Fama recognises that they may reach a point where they determine it is better to collude and expropriate against the security holder than compete against each other. It is then imperative to include outside independent directors to lower the probability of collusion at a low cost. At the same time this will enhance the board as a ‘market-induced mechanism for low-cost internal transfer of control’.⁵⁸³ Thus, agency theorists often see increased board independence as a way to improve monitoring.⁵⁸⁴

⁵⁷⁹ See, for example, K Eisenhardt, ‘Agency Theory: An Assessment and Review’ (1989) 14(1) *Academy of Management Review* 57, 58

⁵⁸⁰ For details on the market for securities or market for corporate control see, H Manne, ‘Mergers and the Market for Corporate Control’ (1965) 73 *Journal of Political Economy* 110; T Baums and K Scott, ‘Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany’ (2005) 53(1) *The American Journal of Comparative Law* 31; G Bittlingmayer, ‘The Market for Corporate Control’ (Edward Elgar, 2000) 725-771 also available at <<http://encyclo.findlaw.com/tablebib.html>> accessed January 19th 2013

⁵⁸¹ E Fama, ‘Agency Problems and the Theory of the Firm’ (1980) 88(2) *Journal of Political Economy* 288, 293; see also, S Ferris, M Jagannathan and A Pritchard, ‘Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments’ (2003) 58(3) *The Journal of Finance* 1087

⁵⁸² L Bebchuk and J Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, (Harvard University Press, 2006) 53; cf. S Gilson, ‘Bankruptcy, boards, banks and blockholders: Evidence on changes in corporate ownership and control when firms default’ (1990) 27(2) *Journal of Financial Economics* 355 – which showed market forces can have some influence

⁵⁸³ E Fama, ‘Agency Problems and the Theory of the Firm’ (1980) 88(2) *Journal of Political Economy* 288, 293

⁵⁸⁴ See, for example, N Vafeas, ‘Further Evidence on Compensation Committee Composition as a Determinant of CEO Compensation’ (2003) 32(2) *Financial Management* 53; J Westphal, ‘Collaboration in the Boardroom: Behavioural and Performance Consequences of CEO-Board Social Ties’ (1999) 42(1) *Academy of Management*

Sundaramurthy and Lewis note that successful insider board structures will often fail to assess causes of performance. Without monitoring this can lead to denial and overconfidence, ignoring needs to restructure and reform.⁵⁸⁵ Other monitoring mechanisms have since been introduced since, such as a separation of the roles of chair and CEO⁵⁸⁶ and an appointment of a senior independent director⁵⁸⁷ to ensure there is not a concentration of power in any one individual on the board.

From agency theory it can be seen that an agent needs to be incentivised and monitored so their utility is maximised by preferring the interests of the principal. There must be effective monitoring through information systems. Shareholders will be disinterested in monitoring and although managers may be good monitors of the company it is ideal for outsiders to be involved to prevent collusion. Secondly, there must also be adequate incentives to reduce

Journal 7; B Baysinger and H Butler, 'Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition' (1985) 1(1) *Journal of Law, Economics and Organization* 101; cf. D Erkens, M Hung and P Matos, 'Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide' (2010) <<http://ssrn.com/abstract=1397685>> date accessed 1st Nov 2010; L Van den Berghe and A Levrau, 'Evaluating Boards of Directors: what constitutes a good corporate board?' (2004) 12(4) *Corporate Governance: An International Review* 461, 466; D Dalton *et al*, 'Meta-Analytic Review of Board Composition, Leadership Structure, and Financial Performance' (1998) 19(3) *Strategic Management Journal* 269

⁵⁸⁵ C Sundaramurthy and M Lewis, 'Control and Collaboration: Paradoxes of Governance' (2003) 28(3) *The Academy of Management Review* 397, 400

⁵⁸⁶ UK Corporate Governance Code 2010, section A.2; K Elsayed, 'Does CEO Duality Really Affect Corporate Performance?' (2007) 15(5) *Corporate Governance: An International Review* 1203; C Weir and D Laing, 'Governance structures, director independence and corporate performance in the UK' (2001) 13(2) *European Business Review* 86; L Donaldson and J Davis, 'Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns' (1991) 16(1) *Australian Journal of Management* 49; J Dahya, A Lonie and D Power, 'The Case for Separating the Roles of Chairman and CEO: An Analysis of Stock Market and Accounting Data' (1996) 4(2) *Corporate Governance: An International Review* 71; P Rechner and D Dalton, 'CEO Duality and Organizational Performance: A Longitudinal Analysis' (1991) 12(2) *Strategic Management Journal* 155

⁵⁸⁷ UK Corporate Governance Code 2010, section A.4.1

the agency problem. As was seen from Fama, and Jensen and Meckling, where it is more optimal for an agent to prefer his own interests he will choose to do so. A compensation package must then be formed to help insulate the company from transgressions. According to agency theory then a non-executive will need to be appropriately monitored and incentivised financially to maximise the possibility that they act for the benefit of the company when taking multiple appointments.

Although agency has prevailed as the predominate theory of corporate governance, competing theories have emerged to explain the existence of the firm. Next this chapter will focus on stewardship theory that has countered agency arguments on what motivates directors.

b. Stewardship Theory

Unlike Agency theory, which derives from an economic perspective, Stewardship theory developed from sociology and psychology perspectives.⁵⁸⁸ Although early literature on stewardship theory tended to highlight the benefits of stewardship to the detriment of agency, recent literature has focused on uniting the two approaches to show how both are relevant.⁵⁸⁹ Stewardship theorists recognised that financial considerations are not the only motivator of individuals.⁵⁹⁰ The theory aims to dispel the notion that belies agency theory,

⁵⁸⁸ J Davis, F Schoorman and L Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22(1) *Academy of Management Review* 20, 24

⁵⁸⁹ See, for example, J Davis, F Schoorman and L Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22(1) *Academy of Management Review* 20; G Nicholson and G Kiel, 'Can Directors Impact Performance? A case-based test of three theories of corporate governance' (2007) 15(4) *Corporate Governance: An International Review* 585; J Roberts *et al*, 'Beyond Agency Conceptions of the Work of the Non-Executive Director' (2005) 16 *British Journal of Management* 5

⁵⁹⁰ R Bender, 'Why Do Companies Use Performance-Related Pay for Their Executive Directors?' (2004) 12(4) *Corporate Governance: An International Review* 521; see also C Barnard, *The Functions of the Executive*,

that directors are inherently self-serving and otiose.⁵⁹¹ Stewardship theorists recognised the need for additional theory to explain their role.

This theory supposes that the greater attachment an individual has with a firm the more he will identify with it. Antecedents to what motivates a steward, as opposed to an agent, are structures that empower and facilitate the steward, with a sense of *esprit de corps*, in contrast to agency theory that focuses on structures that monitor and control. As a result, by trusting and empowering the individual this will result in an alignment of interests. Therefore, stewardship theorists argue that as boards have become more involved in the company the greater the need there is to foster a stewardship model of corporate governance. Evidence has now begun to emerge to highlight the greater involvement boards have in the company. Ingley and Walt showed how directors perceive their involvement in strategy to be one of their most important tasks.⁵⁹² Anderson, Melanson and Maly's study also reported similar results that directors perceived boards to be a strategic asset.⁵⁹³

In regards to the principal's interests, stewardship theory recognises the pro-organisational behaviour of stewards and the nature of ownership in UK firms. Where share ownership is dispersed the shareholders are likely to have competing interests. Thus, stewards are likely to make decisions that are in the best interests of the group, which in turn will satisfy the

(Harvard University Press, 1964) 220-1 – 'It is rather generally understood that although money or other material inducements must usually be paid to responsible persons, responsibility itself does not arise from such inducements'

⁵⁹¹ See, for example, J McConvill, 'Executive Compensation and Corporate Governance: Rising Above the "Pay-for-Performance" Principle' (2006) 43(2) *American Business Law Journal* 413, 415

⁵⁹² C Ingley and N van der Walt, 'Do Board Processes Influence Director and Board Performance' (2005) 13(5) *Corporate Governance: An International Review* 632 at 642

⁵⁹³ D Anderson, S Melanson and J Maly, 'The Evolution of Corporate Governance: power redistribution brings boards to life' (2007) 15(5) *Corporate Governance: An International Review* 780, 784

competing interests of any shareholders.⁵⁹⁴ Sundaramurthy and Lewis identify that: 'A collaborative approach... stresses managers' tendencies to be collectively orientated and intrinsically motivated' allowing stewards to 'identify and internalize with its mission'.⁵⁹⁵ Davis *et al* also note that for a steward, pro-organisation and collectivist behaviour has a higher utility for the individual than self-serving behaviour.⁵⁹⁶ Davis *et al* go on to note that a steward will protect the principal's best interests because this will maximise his own utility. Here there is a similarity between agency and stewardship theories, that the ultimate motivation of the agent/steward is still personal utility maximisation.⁵⁹⁷ Both theories see the agent/steward as a utility maximizer that attempts to find co-efficient ways of motivating the individual to align interests and maximise the wealth of the principal. Although the methods used by each theory are mirrored, the outcomes sought are similar. Thus, the onus is on the principal to ensure that the governance structure facilitates the individual's needs to reduce possible conflict.

Stewardship theory recognises a director's need for an income but argues that motivation comes from intrinsic methods or intangible benefits that do not necessarily have a quantifiable economic value.⁵⁹⁸ Accordingly, a steward's performance and motivation will be affected by the governance structure. Davis *et al* identify six psychological factors that will

⁵⁹⁴ J Davis, F Schoorman and L Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22(1) *Academy of Management Review* 20, 25

⁵⁹⁵ C Sundaramurthy and M Lewis, 'Control and Collaboration: Paradoxes of Governance' (2003) 28(3) *The Academy of Management Review* 397, 398

⁵⁹⁶ J Davis, F Schoorman and L Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22(1) *Academy of Management Review* 20, 24

⁵⁹⁷ M Jackson, 'An Overview of Social Networks and Economic Applications' (2009) *Handbook of Social Economics* 1, 32

⁵⁹⁸ See, J Davis, F Schoorman and L Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22(1) *Academy of Management Review* 20, 27-28

foster a steward: (1) Motivation; (2) Identification; (3) Use of power; (4) Management philosophy; (5) Culture; and (6) Power distance.⁵⁹⁹ A governance structure that empowers a steward that is pro-organisational will reduce the need for agency costs, increasing firm performance as the individual can be trusted. For example, a board dominated by insiders will set better remuneration as they are more in touch with the organisation,⁶⁰⁰ or insiders with stewardship characteristics will perform better, making superior decisions,⁶⁰¹ when given higher authority and discretion⁶⁰² i.e. chairing the board.⁶⁰³ Conversely a steward's motivation will be lowered if the governance structure consists of monitoring and control. Sundaramurthy and Lewis note that an over emphasis on monitoring will cause tension resulting in 'defences that suppress stewardship, inhibit information flow, and engender the very behaviours the approach seeks to curb'.⁶⁰⁴ The stewardship model also notes that as

⁵⁹⁹ J Davis, F Schoorman and L Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22(1) *Academy of Management Review* 20, 27-37

⁶⁰⁰ B Boyd, 'Board Control and CEO Compensation' (1994) 15(5) *Strategic Management Journal* 335

⁶⁰¹ i.e. those linked to sustainability, balanced compensation, quality of information

⁶⁰² L Donaldson and J Davis, 'Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns' (1991) 16(1) *Australian Journal of Management* 49 – empirical evidence from US corporations showed an above average of return on equity where there was CEO-Chair duality; see also, D Dalton *et al*, 'Meta-Analytic Review of Board Composition, Leadership Structure, and Financial Performance' (1998) 19(3) *Strategic Management Journal* 269; J Dahya, A Lonie and D Power, 'The Case for Separating the Roles of Chairman and CEO: An Analysis of Stock Market and Accounting Data' (1996) 4(2) *Corporate Governance: An International Review* 71

⁶⁰³ UK Corporate Governance Code 2010 Section A.2 - However, the Code recommends separation of these roles; and investors tend to show distaste for a combination of the roles – see, for example, J Davey and J Ashton, 'Standoff over Stuart Rose's executive chairman plan at Marks & Spencer' *The Times* (London 30th Mar 2008) <http://business.timesonline.co.uk/tol/business/industry_sectors/retailing/article3645060.ece> accessed 13th April 2011

⁶⁰⁴ C Sundaramurthy and M Lewis, 'Control and Collaboration: Paradoxes of Governance' (2003) 28(3) *The Academy of Management Review* 397, 403

well as monitoring affecting motivation, outsiders will lack knowledge and time necessary to perform the tasks.⁶⁰⁵

Stewardship theory largely mirrors that of agency. Its main features are trust and empowerment. These features allow a steward, as a pro-organisational individual, to identify with the firm that will maximise their own utility. Directors are motivated to collaborate with management to utilise their skill and knowledge of the firm. As seen above, evidence is increasingly emerging of the changing role of the board, identifying the board as a strategic asset connected with management. Stewardship theory would predict that the best way for non-executives to use external appointments for the benefit of the firm would be to have a board structure that trusts and empowers rather than control and monitoring.

c. Resource dependence theory

The final theory to consider is resource dependence theory. This theory has identified that agency and stewardship theory focus their analysis on providing incentives to monitor at the expense of analysing whether the board actually has the ability to monitor. For example, rewarding a director with PRP may be redundant if the director cannot perform the task or sees it as unachievable.⁶⁰⁶ Erkens *et al* identified that boards with expertise outperformed

⁶⁰⁵ See L Donaldson and J Davis, 'Boards and Company Performance: Research Challenges the Conventional Wisdoms' (1994) 2(3) *Corporate Governance: An International Review* 151; although evidence often fails to make a strong link between insiders and corporate performance: See for example G Nicholson and G Kiel, 'Can Directors Impact Performance? A case-based test of three theories of corporate governance' (2007) 15(4) *Corporate Governance: An International Review* 585 at 588; C Daily and D Dalton, 'Board of Directors Leadership and Structure: Control and Performance Implications' (1993) 17(3) *Entrepreneurship: Theory and Practice* 65

⁶⁰⁶ A Hillman and T Dalzell, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383, 389; J McConvill, 'Executive

those that were independent.⁶⁰⁷ Both monitoring and expertise can be seen as important: 'In light of current developments concerning non-executive directors the ... framework for such directors must fully recognise that they are both a resource to, and a constraint on, managerial action.'⁶⁰⁸

Resource dependence theory has developed to acknowledge that directors can be a valuable resource to the firm. Directors provide "human capital"⁶⁰⁹ such as networks and expertise, and close connections with strategy can utilise these benefits for appropriate supervision and firm performance.⁶¹⁰ Directors with greater human capital will have more value in the managerial labour market. Their increased value will be beneficial to the firm as they will be better at monitoring and engaging with strategy. For non-executives resources that will help monitor and advise on strategy are likely to be regarded highly.

Fama and Jensen⁶¹¹ demonstrated that a director's worth would be signalled by efficient managerial labour markets. Thus, a director's human capital can be ascertained. Factors such as compensation, value of the company, whether the company is subject to takeovers, how many directorships or networks the director has will all signal the value of the director.

Compensation and Corporate Governance: Rising Above the "Pay-for-Performance" Principle' (2005) 43(2) *American Business Law Journal* 413, 416

⁶⁰⁷ D Erkens, M Hung and P Matos, 'Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide' (2010) <<http://ssrn.com/abstract=1397685>> accessed 1st Nov 2010

⁶⁰⁸ P Wickham and P Townsend, 'The non-executive director: a management perspective' (1994) 15(7) *Company Lawyer* 211

⁶⁰⁹ A Hillman and T Dalzell, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383

⁶¹⁰ A Hillman and T Dalzell, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383, 385-6

⁶¹¹ E Fama and M Jensen, 'Separation of Ownership and Control' (1983) 26(2) *Journal of Law and Economics* 301

Networks from the director can be seen as an important resource to firms.⁶¹² They can provide access to materials and finance, and they can also supply information that can provide a picture closer to true state of affairs related to the firm. Resource dependence theory would submit that multiple directorships are beneficial, as it will 'help reduce dependency between the organization and external contingencies, diminish uncertainty for the firm, lower transaction costs, and ultimately aid the survival of the firm'.⁶¹³ Research has suggested that directors who have multiple appointments will have greater human capital⁶¹⁴ and thus better monitors for the company.⁶¹⁵ This ability to monitor will serve as a determinant to who gets appointed as a director. Accordingly, the research shows that there is a reputational effect in the market for directors providing evidence to support Fama and Jensen. Therefore those directors with multiple appointments, according to agency theory and resource dependence theory, are valuable. Motivating the individual to use this access, and resources it brings, to the firm's advantage is imperative in the relationship between these two theories.

⁶¹² See, for example, ARM Holdings plc, *Annual Report 2009*, 53 – 'It is the Company's policy to allow executive directors to hold non-executive positions at other companies and to receive remuneration for their services. The board believes that experience of the operations of other companies and their boards and committees is valuable to the development of the executive directors'

⁶¹³ A Hillman and T Dalziel, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383, 386

⁶¹⁴ See, for example, J Pfeffer, 'Organization Theory and Structural Perspectives on Management (1991) 17(4) *Journal of Management* 789 – Pfeffer argued that interlocks increases access to strategic information and opportunities

⁶¹⁵ S Ferris, M Jagannathan and A Pritchard, 'Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments' (2003) 58(3) *The Journal of Finance* 1087

However, recent research has reached conflicting conclusions.⁶¹⁶ Qi shows it is the director's networks and social ties to the board and not managerial labour markets that result in multiple directorships and who gets appointed to the board. The research finds aspects of human capital are negligible determinants of board appointments and thus multiple directorships, providing no support for Fama and Jensen. If social networks are a primary determinant of board appointments then it is decisions made on appointments are not made in the principal's interests. Thus, Qi's research suggests that multiple directorships do not help to align interests, and incentives for directors are unlikely to have their intended effect. It also signals multiple directors are not necessarily better monitors with more human capital since they are not there on their merits. Alternatively, Eisenhardt and Schoonhoven⁶¹⁷ showed that social ties are created at a higher rate where management performance, expertise etc is higher. Ultimately it appears that a firm must balance allowing for multiple directorships but not facilitating an over consumption through its governance structure.

Despite this resource dependence theory does not necessarily see board dependence⁶¹⁸ as negative since they encourage information transfer between those on the board⁶¹⁹ and thus the director is motivated to supply their resources to the firm. Stewardship and resource dependence theory would then value multiple appointments because they can foster a

⁶¹⁶ Qianru Qi, 'How Does the Director's Social Network Matter? Evidence From Structure Estimation' (2010) <<http://ssrn.com/abstract=1786555>> accessed 14th April 2011; S Bhagat and B Black, 'The Non-Correlation Between Board Independence and Long-Term Firm Performance' (2002) *Stanford Law and Economics Olin Working Paper No 185* available at <<http://ssrn.com/abstract=133808>> accessed 10th September 2013; D Yermack, 'Higher market valuation of companies with a small board of directors' (1996) 40(2) *Journal of Financial Economics* 185

⁶¹⁷ See, for example, K Eisenhardt and C Schoonhoven, 'Resource-Based View of Strategic Alliance Formation: Strategic and Social Effects in Entrepreneurial Firms' (1996) 7(2) *Organization Science* 136, 138, 146

⁶¹⁸ The level of networks between board members

⁶¹⁹ J Westphal, 'Collaboration in the Boardroom: Behavioural and Performance Consequences of CEO-Board Social Ties' (1999) 42(1) *Academy of Management Journal* 7

collaborative approach. Yet in terms of monitoring the theory recognises that greater dependence will reduce the incentive to monitor.⁶²⁰ Therefore, whilst greater connections with management may be beneficial for motivating the non-executive to take and use external appointments for the benefit of the company this may result in a trade-off with effective monitoring.

Resource dependence theory essentially involves board features that increase knowledge and expertise of the firm and facilitate the provision of those resources to the benefit of the firm. Larger boards will provide access to more resources for example. If the majority of the board members are insiders this increases board dependence and may be more willing to provide advice and counsel.⁶²¹ A compensation structure that facilitates the provision of the director's human capital has not clearly been considered by the literature. Some argue equity based compensation structures will be beneficial.⁶²² However, if a director is to provide his resources to benefit the firm, equity rewards may force them to commit to one firm so as to receive any benefit, which may in fact hinder his or her human capital. They

⁶²⁰ R Masulis and S Mobbs, 'Are all Inside Directors the Same? Evidence from the External Directorship Market' (2011) 66(3) *The Journal of Finance* 823; N Vafeas, 'Further Evidence on Compensation Committee Composition as a Determinant of CEO Compensation' (2003) 32(2) *Financial Management* 53; A Hillman and T Dalzell, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383; B Baysinger and H Butler, 'Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition' (1985) 1(1) *Journal of Law, Economics and Organization* 101

⁶²¹ See, for example, A Hillman and T Dalzell, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383, 391; J Westphal, 'Collaboration in the Boardroom: Behavioural and Performance Consequences of CEO-Board Social Ties' (1999) 42(1) *The Academy of Management Journal* 7 – who showed social ties between board and CEO increased frequency of advice which enhance firm performance

⁶²² A Hillman and T Dalzell, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383, 390

may also see the financial rewards of equity compensation as unachievable or negligible especially if the firm is underperforming or in difficult market conditions.⁶²³ Therefore, for a firm to benefit from the human capital provided through multiple appointments the compensation package should favour fixed compensation.

IV. GOVERNANCE THEORIES AND RISK

Individual governance theories attempt to explain how the conflicting objectives of parties can be brought in to alignment to benefit the principal's interests. Yet, any number of variables may influence the incentives of the individual. In this section of the chapter, competing governance theories will be considered and compared to identify the risk a certain governance structure according to one theory is perceived by the others. Modern boards are diverse containing features of each of the theories discussed. Since modern boards do not fit in to any particular model, understanding how each theory understands or views the risk of the other governance structures is important. This can counter risk, provide incentives to the non-executive whilst at the same time ensuring they can adequately monitor and provide resources and ultimately help maximise the chance they act for the benefit of the company. Whilst managers are likely to attribute blame to their subordinates it is more likely that a faulty structure is a better explanation.⁶²⁴

Figures one, two and three of this chapter show how different theories view different board features. Figure four will assess the current UK position from the Corporate Governance Code to demonstrate the potential risks associated with a recommended structure for non-executives. Using elements highlighted in the previous section, the tables indicate the risk

⁶²³ E Fich and A Shivdasani, 'Are Busy Boards Effective Monitors?' (2006) 61(2) *The Journal of Finance* 689; K Eisenhardt and C Schoonhoven, 'Resource-Based View of Strategic Alliance Formation: Strategic and Social Effects in Entrepreneurial Firms' (1996) 7(2) *Organization Science* 136

⁶²⁴ C Perrow, *Complex Organizations: A critical essay* (3rd edn, McGraw Hill 1986) 224, 235

levels of a board feature would have on bringing about an alignment of interests based on the theoretical underpinnings of any given board. For example, if the company wishes to maximise its access to resources the board will need to be larger than average, directors with low equity levels amongst other features. Accordingly, agency and stewardship see both these features as potentially harmful based on the underpinnings of their theories that the directors will seek to maximise their own utility. Whilst resource dependence theory would contend the increased access is beneficial to aligning interests, agency and stewardship may see it as harmful to the alignment of interests. Thus a board's structure needs to account for these factors. Eisenhardt and Schoonhoven⁶²⁵ showed that increased resources through interlocks and social ties can help form strong strategic alliances. These will be particularly beneficial when market conditions become difficult. Increasing a firm's access to resources, e.g. through the appointment of an additional director who has relevant multiple appointments, in difficult market conditions needs to be balanced against potential implications such as increased board dependence and reduced monitoring. Thus whilst moving closer to a resource dependence theory model in difficult market circumstances may be beneficial it is possible that it will increase the risk that a non-executive will seek to prefer their own interests. This may be more so where the firm is underperforming and the non-executive brought in for their resources may depart and take any potential opportunities with them to another company.⁶²⁶ Another example may be increasing equity payments. Agency theory may see this as increasing the alignment of interests, stewardship may see it as increased monitoring and endanger the flow of information, and resource dependence theory may contend that such rewards may be unachievable where the individual does not have the resources and thus does not act for the benefit of the company. Figure 1 shall consider agency theory.

⁶²⁵ K Eisenhardt and C Schoonhoven, 'Resource-Based View of Strategic Alliance Formation: Strategic and Social Effects in Entrepreneurial Firms' (1996) 7(2) *Organization Science* 136

⁶²⁶ E Fich and A Shivdasani, 'Are Busy Boards Effective Monitors?' (2006) 61(2) *The Journal of Finance* 689

Fig 1: Board risks according to agency theory

	Agency Theory	Stewardship T.	Resource Dep. T.
Agency Board Features			
High Compensation	Green	Yellow	Yellow
High PRP	Green	Red	Red
Medium multiple directorships	Green	Yellow	Yellow
High non-exec levels	Green	Yellow	Green
High independent non-exec levels	Green	Red	Red
High equity ownership	Green	Yellow	Red
Average size board	Green	Yellow	Yellow
Frequent Board Meetings (inc committees)	Green	Yellow	Green
Separation of CEO and Chairman	Green	Red	Yellow
Non-Executive Role: Monitor	Green	Red	Yellow

NB: green = low risk; yellow = medium risk; red = high risk

The risk levels of a “model” agency board are logically minimal according to agency theory. As the chapter highlighted in the previous section ownership is dispersed and monitoring and control are important. Thus, fundamental features focus on outcome-based elements of compensation and high levels of monitoring activity. However, it is identified that the risk levels rise according to the other two theories. As Ingley and Walt⁶²⁷ demonstrated boards have continually moved towards a stewardship model that views the board as a strategic

⁶²⁷ C Ingley and N van der Walt, ‘Do Board Processes Influence Director and Board Performance’ (2005) 13(5) *Corporate Governance: An International Review* 632

asset with increased responsibility.⁶²⁸ As non-executives become more involved, a structure that focuses on monitoring may inhibit the flow of information according to stewardship theory.⁶²⁹ Resource dependence theory may not see a pure monitoring role for non-executives as harmful to the alignment of their interests as the theory recognises that those with more resources will provide better input to the board.⁶³⁰ However, if the role is restricted to monitoring this may inhibit the use of resources they can provide as a strategic asset.⁶³¹ Perhaps the biggest inconsistency is the issue of equity ownership and PRP for alignment of interests in multiple appointments. A board focusing on agency theory would have to address the amount of equity ownership in comparison with the amount of directorships the individual holds. If the firm wishes to solely function on agency theory then it would increase or have high equity ownership and PRP to deter perquisite directorship consumption.⁶³² Yet high *ex post* remuneration may mean that interest alignment is not achieved if the individual sees the rewards as negligible or as unachievable,⁶³³ meaning they could depart the company or take on additional appointments as perquisite consumption.⁶³⁴ Higher equity ownership then has a trade off with potential access to resources. Additional

⁶²⁸ See, for example, Grant Thornton Corporate Governance Review, 'A Changing Landscape' (2010), 5; Standard Chartered plc, *Annual Report 2009*, 103

⁶²⁹ C Sundaramurthy and M Lewis, 'Control and Collaboration: Paradoxes of Governance' (2003) 28(3) *The Academy of Management Review* 397, 403

⁶³⁰ A Hillman and T Dalziel, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383

⁶³¹ P Wickham and P Townsend, 'The non-executive director: a management perspective' (1994) 15(7) *Company Lawyer* 211

⁶³² S Ferris, M Jagannathan and A Pritchard, 'Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments' (2003) 58(3) *The Journal of Finance* 1087, 1097

⁶³³ E Fich and A Shivdasani, 'Are Busy Boards Effective Monitors?' (2006) 61(2) *The Journal of Finance* 689

⁶³⁴ L Renneboog and Y Zhao, 'Us knows us in the UK: On director networks and CEO compensation' (2011) 17(4) *Journal of Corporate Finance* 1132; cf. S Ferris, M Jagannathan and A Pritchard, 'Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments' (2003) 58(3) *The Journal of Finance* 1087

risks may be the amount of independent non-executives appointed to the board. Resource dependence and stewardship theory would foresee this as a potential risk to interest alignment, as they may be incapable of contributing due to a lack of expertise as well as increased monitoring.⁶³⁵ Therefore additional appointments may become perquisite consumption in such circumstances as well.

Fig 2: Board risks according to stewardship theory

	Agency Theory	Stewards hip T.	Resource Dep. T.
Stewardship Board Features			
Normal Compensation			
Low PRP			
Few multiple directorships			
Low non-exec levels			
Low independent non-exec levels			
Low equity ownership			
Small board			
Infrequent Board Meetings (inc committees)			
Combination of CEO and Chairman			
Non-Executive Role: Engage with strategy			

Stewardship theory appears to have a fairly negative relationship with Resource dependence theory. However, the issue of multiple directorships can be overcome. Although

⁶³⁵ D Erkens, M Hung and P Matos, 'Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide' (2010) <<http://ssrn.com/abstract=1397685>> accessed 1st Nov 2010; C Sundaramurthy and M Lewis, 'Control and Collaboration: Paradoxes of Governance' (2003) 28(3) *The Academy of Management Review* 397, 403

stewardship theory would propose that multiple directorships are a strain on a director's time, if this multiple directorship can increase the value of the firm by access to resources it will increase the individual's utility.⁶³⁶ The director will have more power and access to resources that can improve the value of the firm. However, a company focusing on stewardship would have to ensure that the additional directorships do not strain the director to identify with different firms that may cause a misalignment of interests and create potential conflicts. To restrict perquisite multiple appointments the firm needs to develop a structure that allows identification with the firm, which would be achieved through trust and empowerment i.e. with fewer independent non-executives and a combination of the CEO-Chair roles. Therefore multiple directorships are plausible under a stewardship model but increasing access to resources through them can be difficult due to theoretical constraints on board size and non-executive levels that can provide access to these resources. Under a stewardship model it is harder to facilitate access to resources. It can be hypothesised that a stewardship model is more suited to a firm established in the market. Sundaramurthy and Lewis demonstrated how directors tend to disassociate themselves from firms facing difficulties.⁶³⁷ A stewardship-resource dependence model is then unlikely to increase access to resources if the firm is underperforming and will not align the interests of the parties.

Figure three demonstrates the board features of a resource dependence theory board. As can be seen the features are designed to facilitate access to resources. The role of the non-executive is to contribute to monitoring and strategy so they are able to serve as a constraint on and asset to managerial action.⁶³⁸

⁶³⁶ J Davis, F Schoorman and L Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22(1) *Academy of Management Review* 20

⁶³⁷ C Sundaramurthy and M Lewis, 'Control and Collaboration: Paradoxes of Governance' (2003) 28(3) *The Academy of Management Review* 397, 402

⁶³⁸ P Wickham and P Townsend, 'The non-executive director: a management perspective' (1994) 15(7) *Company Lawyer* 211

Fig 3: Board risks according to resource dependence theory

	Agency Theory	Stewards hip T.	Resource Dep. T.
Resource Dependence Board Features			
Normal Compensation	Yellow	Green	Green
Low PRP	Red	Green	Green
High Multiple directorships	Yellow	Red	Green
High non-exec levels	Green	Yellow	Green
Low independent non-exec levels	Red	Green	Green
Low equity ownership	Red	Green	Green
Large Board	Red	Red	Green
Frequent Board Meetings (inc committees)	Green	Yellow	Green
Non-Executive Role: Monitor and engage with strategy	Yellow	Yellow	Green

Therefore the individual director is capable of applying all their resources to the company. Frequent board meetings can also increase the flow of resources that the non-executive can provide. Yet the key is using agency or stewardship aspects to motivate directors to provide these resources. From the previous two figures there are inconsistencies between stewardship-resource dependence and agency-resource dependence models and there is no need to repeat them here. Perhaps the biggest obstacle to a “resource dependence theory board” is the size. Ferris *et al* demonstrated that boards with more multiple directorships were generally larger.⁶³⁹ Agency and stewardship both have negative

⁶³⁹ S Ferris, M Jagannathan and A Pritchard, ‘Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments’ (2003) 58(3) *The Journal of Finance* 1087

relationships with large boards for different reasons.⁶⁴⁰ Having a larger board then to facilitate access to resources needs to consider the risk it may bring to incentivising the individual. Here there is the risk that having a larger board may increase the access to resources so there is better monitoring may have to be traded off against the risk that the board become unwieldy and incapable of performing its functions efficiently.

The corporate governance structure of any board needs to be considered carefully to maximise the possibility of incentives working *ex ante* to align the interests of the non-executive with the company. From the figures it is observed that there are potential trade offs with maximising access to resources and incentivising the individual to provide them. A company needs to consider carefully how it structures its governance so that additional appointments and the resources they bring are for the benefit of the company and not perquisite consumption for the individual.

Figure four can now consider the current recommended UK approach to corporate governance in the Corporate Governance Code.

⁶⁴⁰ See, UK Corporate Governance Code, B.1; D Yermack, 'Higher market valuation of companies with a small board of directors' (1996) 40(2) *Journal of Financial Economics* 185; T Eisenberg, S Sundgren and T Wells, 'Larger board size and decreasing firm value in small firms' (1998) 48(1) *Journal of Financial Economics* 35; M Jensen, 'The modern industrial revolution, exit and the failure of internal control systems' (1993) 48(3) *Journal of Finance* 831; Y Mak and Y Kusnadi, 'Size really matters: further evidence on the negative relationship between board size and firm value' (2005) 13(3) *Pacific-Basin Finance Journal* 301

Fig 4: Recommended board features and risk

	Agency Theory	Stewardship T.	Resource Dep. T.
Recommended Board Features			
Compensation: should attract, retain and motivate – Section D			
Independence: at least half the board – Section B			
Size: Sufficient size but not too large to be unwieldy – Section B			
Multiple directorships – For execs no more than 1; Non-execs enough time for duties – Section B			
Equity ownership: No restrictions in the Code			
Non-execs: at least half the board – Section B			
Board meetings: No restrictions in the Code			
PRP: Significant proportion – Section D			
Separation of CEO and Chairman: Section A			
Non-Executive Role: Monitor and engage in strategy			

The figure demonstrates that the Corporate Governance Code is heavily influenced by agency theory. Yet it is important to remember that the Code works on a ‘comply or explain’

basis,⁶⁴¹ and certain features above are still left open for a corporation to decide how to structure their board and what incentives to offer. Thus, any convergence of boards towards an agency model cannot be solely attributable to the Code, although in 2010 it was evidenced that out of the FTSE 350 firms, 51% complied in full with the Code.⁶⁴² Working on a 'comply or explain' basis the Code sets out guidance on how the company should be governed and how to align the interests of the principal and agent. The Code focuses heavily on effective monitoring and incentives, which agency theory literature sees as key to aligning interests. Accordingly, the Code provides that boards should be weighted in favour of outside independent directors.⁶⁴³ This is due to the perceived detriments of board dependence.⁶⁴⁴ Yet as theories such as Stewardship and resource dependence would contend board independence might not help align interests. If a non-executive is going to take and use multiple appointments to the firm's advantage, thus aligning his or her interests, resource dependence would contend that the individual would need to have the ability to provide those resources which it is consider that independent directors lack.⁶⁴⁵

⁶⁴¹ UK Corporate Governance Code, pg 4; For literature on comply or explain see, Financial Reporting Council 'Comply or Explain: 20th Anniversary of the UK Corporate Governance Code' (2012) <<http://www.frc.org.uk/getattachment/823aa805-72a6-471f-a9be-ccade4737995/Comply-or-Explain-20th-Anniversary-of-the-UK-Corporate-Governance-Code.aspx>> accessed 5th Sep 2013

⁶⁴² Grant Thornton Corporate Governance Review, 'A Changing Landscape: Are you ready?' (2010) <http://www.grant-thornton.co.uk/thinking_blogs/publications/corporate_governance_review.aspx> accessed 14th Mar 2011

⁶⁴³ UK Corporate Governance Code 2010 Section B.1.2

⁶⁴⁴ i.e. a board dominated by insiders, see, for example, A Hillman and T Dalzell, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383, 385; E Fama, 'Agency Problems and the Theory of the Firm' (1980) 88(2) *Journal of Political Economy* 288, 293

⁶⁴⁵ D Erkens, M Hung and P Matos, 'Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide' (2010) <<http://ssrn.com/abstract=1397685>> accessed 1st Nov 2010

Therefore additional appointments taken may be of little benefit to the firm due to the lack of expertise the independent director has and are taken as perquisite consumption.

As for remuneration to incentivise non-executives to provide additional appointments for the benefit of the firm there may too be a trade-off. They are predominately paid in fees, and in most cases a small percentage of equity to the company's share capital, which agency theory would predict as a risk that could create additional agency costs as non-executives are able to take additional perquisites in the form of additional appointments at lower personal cost to themselves.⁶⁴⁶ However, a higher ratio of fixed compensation may be beneficial as it means the non-executive does not focus his or her efforts on one firm, thus is not dependent on any one firm⁶⁴⁷ and does not see rewards as unachievable or negligible.⁶⁴⁸ Aligning interests according to the governance theories through rewards then must be careful of the potential trade-off between taking additional appointments due to low personal cost and allowing the non-executive to use their resources to the benefit of the company.

Although the Code tries to restrict conflicts of interest from the executive directors through increasing independence, board committees and PRP an over-emphasis on these features can be potentially negative to aligning the interests of the non-executive. It encourages firms to conform to a single model of corporate governance that creates unnecessary agency costs for firms with an increase of firm compliance in the FTSE 350 from 28% to 51% between 2005 and 2010.

⁶⁴⁶ S Ferris, M Jagannathan and A Pritchard, 'Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments' (2003) 58(3) *The Journal of Finance* 1087

⁶⁴⁷ R Masulis and S Mobbs, 'Are all Inside Directors the Same? Evidence from the External Directorship Market' (2011) 66(3) *The Journal of Finance* 823

⁶⁴⁸ E Fich and A Shivdasani, 'Are Busy Boards Effective Monitors?' (2006) 61(2) *The Journal of Finance* 689

V. CONCLUSION

This chapter set out to discuss the effects multiple directorships can have on the governance of a firm and the theory behind ways corporate governance in a company may be structured to incentivise *ex ante* the non-executives to align their interests with the company's. It can be seen that multiple appointments can be beneficial but also perquisite consumption for the individual. Therefore, instead of restricting multiple appointments, structuring the company's governance in a way that incentivises the non-executive to take additional appointments for the benefit of the firm, and to continue to act for the benefit of the firm whilst in that appointment, will reduce the potential for perquisite consumption.

Competing theories of agency, stewardship and resource dependence demonstrate that ensuring multiple appointments are taken for the benefit of the company may result in trade offs elsewhere with the governance of the company. Larger boards, lower independence and fixed compensation may facilitate additional appointments, which resource dependence theory sees as beneficial since those with more resources will perform better; but this may also increase the risk of board dependence, lower personal risk to the non-executive and decreased monitoring which causes the non-executive to side with the executives rather than the company.⁶⁴⁹ Creating the most efficient structure to incentivise non-executives to provide resources and monitor will often require a detailed consideration of the corporate governance mechanisms at any particular firm.

There is also a potential concern that boards are increasingly structuring the governance of their company in accordance with the Corporate Governance Code, which is heavily favours agency theory. Such a structure may not align the interests of the non-executive and company meaning additional appointments are taken as perquisite consumption. Increased

⁶⁴⁹ A Hillman and T Dalziel, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28(3) *The Academy of Management Review* 383, 385

independence and fixed compensation may mean non-executives are not incentivised to provide their resources due to a lack of expertise as an outsider, which can inhibit the flow of information and allows the non-executives to take additional appointments as perquisite consumption due to the lower personal cost to themselves that may reduce the potential for proper oversight of management.

It seems the emphasis of corporate governance is to reduce the risk of conflict between the executive directors and the company. However, more attention should be focused on how non-executives, who are appointed to reduce that risk, are incentivised as they become more involved in the company so they do provide that adequate protection of the company's interests.

Chapter VI

Multiple appointments and perquisite consumption: Empirical evidence

Except for a few recent and tentative steps ... we have no theory which explains how the conflicting objectives of the individual participants are brought in to equilibrium.⁶⁵⁰

Effective boards depend as much on behaviours and relationships as on procedures and structures... I do not presume a “one size fits all” approach to governance is appropriate. There will always be exceptions, but this does not negate the need to establish the expected norm.⁶⁵¹

I. CONTROLLING MULTIPLE APPOINTMENTS

Previous chapters have investigated how a non-executive may be deterred from self-interest through the imposition of the fiduciary duty of loyalty; and how theory supposes boards may be structured to incentivise individuals *ex ante* to align their interests with the principal's. Now, it is the purpose of this chapter to provide empirical analysis of non-executive self-interest by using their multiple directorships as an outcome variable to determine what influences their decision to take additional appointments. This analysis can identify governance mechanisms that can control self-interest. The study will also demonstrate the influence multiple appointments can have on aligning the interests of the executive directors. Since their role is focused on reducing conflict amongst executives, then increased problems within the firm in relation to its governance of the executives would suggest that multiple appointments are based on self-interest and not the interests of the firm. Finally, this study will be conducted through a multi-level analysis by collecting data from firms over a five-year

⁶⁵⁰ M Jensen and W Meckling, 'Theory of the Firm: Managerial behaviour, agency costs and ownership structures' (1976) 3(4) *Journal of Financial Economics* 305, 307

⁶⁵¹ The Higgs Report, *Review of the role and effectiveness of non-executive directors*, (January, 2003) para 1.18-9

period of 2006-2010 to identify any changes based on market conditions before and after the economic recession in 2008.

Agency theory would contend that the taking of multiple directorships by non-executives is a form of perquisite consumption⁶⁵² that, in excess, can be detrimental to the firms involved for a number of reasons and can generate agency costs. For example, appointments may be based on contacts and networks rather than merit or signals from the managerial labour market.⁶⁵³ This may lead to excessive executive compensation⁶⁵⁴ due to the non-executives being unwilling to challenge the executives who supported their appointment. Non-executives may also be unable to fulfil all their duties for each one of their undertakings at the different firms.⁶⁵⁵ This chapter is not, however, advocating that firms should prevent non-executives from taking any external appointments, as there are often many benefits in doing so. Benefits include reducing uncertainties in the market⁶⁵⁶ and improvements in firm

⁶⁵² S Ferris, M Jagannathan and A Pritchard, 'Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments' (2003) 58(3) *The Journal of Finance* 1087

⁶⁵³ E Fama and M Jensen, 'Separation of Ownership and Control' (1983) 26(2) *Journal of Law and Economics* 301; L Bebchuk and J Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, (Harvard University Press, 2006); Qianru Qi, 'How Does the Director's Social Network Matter? Evidence From Structure Estimation' (2010) <<http://ssrn.com/abstract=1786555>> accessed 14th April 2011

⁶⁵⁴ L Renneboog and Y Zhao, 'Us knows us in the UK: On director networks and CEO compensation' (2011) 17(4) *Journal of Corporate Finance* 1132

⁶⁵⁵ S Ferris, M Jagannathan and A Pritchard, 'Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments' (2003) 58(3) *The Journal of Finance* 1087, 1088; citing M Lipton and J Lorsch, 'A modest proposal for improved corporate governance' (1992) 48 *Business Lawyer* 59

⁶⁵⁶ See, for example, K Eisenhardt and C Schoonhoven, 'Resource-Based View of Strategic Alliance Formation: Strategic and Social Effects in Entrepreneurial Firms' (1996) 7(2) *Organization Science* 136; J Pfeffer, 'Organization Theory and Structural Perspectives on Management (1991) 17(4) *Journal of Management* 789

performance.⁶⁵⁷ The point is to highlight how firms may control an excess of external appointments and this may serve as a partial answer as to how a firm can create an alignment of interests to prevent or guard against opportunism and potentially reduce agency costs.

This analysis uses a dataset compiled from the annual reports of thirty FTSE 100 firms over a five-year period from 2006 to 2010. The dataset is designed to use the board features identified in Chapter V to discover how corporate governance mechanisms relate to multiple directorships. By using a time series⁶⁵⁸ this analysis also offers insight into how changing market conditions may impact on multiple directorships. Another contribution this chapter aims to make is the relationship between multiple appointments and agency problems. The study identifies several proxies of agency problems within a firm and measures their relationship with multiple appointments. The amount of agency problems present in any given firm may vary. Executives may be more able than others to impose higher agency costs. Agency theory would predict this is due to insufficient monitoring from the independent non-executives. A reason why non-executives are not monitoring effectively may be from their own external appointments that they have viewed as perquisite consumption. Therefore one may predict that where a firm has more multiple directorships then the firm will also have greater agency problems. Thus, evidence is provided that external appointments may result in greater disparity between the interests of company and non-executive.

It is possible that the analysis will reveal that governance mechanisms may not be significant enough on their own to incentivise non-executives *ex ante* to prefer the interests of the firm. Therefore, to begin with this chapter shall consider whether placing restrictions on multiple

⁶⁵⁷ J Cotter, A Shivdasani, M Zenner, 'Do independent directors enhance target shareholder wealth during tender offers?' (1997) 43(2) *Journal of Financial Economics* 195

⁶⁵⁸ Data collected is also a panel which would allow for control of firm and organisation type in future studies

appointments may be beneficial in deterring self-interest. This will be done through a comparative analysis of board restrictions within the EU in part two. Some testable hypotheses are identified in Part III from the literature discussed in Chapter V. The next sections shall provide a methodology, analysis and results before concluding with some observations and recommendations. By analysing the effects of corporate governance mechanisms on non-executive multiple directorships and the effect they can have on executive directors, recommendations and observations on the norms and limits on the number of external appointments can be made.

II. LIMITS ON MULTIPLE DIRECTORSHIPS: A PERSPECTIVE FROM THE EU

The European Commission has no set rules on the amount of board mandates any one individual is allowed to hold but how to regulate them has been an issue of some considerable debate.⁶⁵⁹ States across the EU can place their own restrictions on multiple appointments that are detailed in Table A. The UK's Corporate Governance Code (hereinafter The Code) adopted the recommendation from the Higgs Report⁶⁶⁰ that executives should only accept a maximum of one additional non-executive appointment of a FTSE 100 firm.⁶⁶¹ For non-executives The Code merely states that directors should ensure that have enough time to fulfil their duties.⁶⁶²

⁶⁵⁹ European Commission, *Green Paper: The EU Corporate Governance Framework*, 5.4.2011 COM(2011) 164, 7-8; For some recent UK proposals see ---, 'FRC to consult on executive remuneration' 20th June 2012 <<http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/June/FRC-to-consult-on-executive-remuneration.aspx>> accessed 5th August 2012

⁶⁶⁰ The Higgs Report, *Review of the role and effectiveness of non-executive directors*, (January, 2003) Para 12.19

⁶⁶¹ The UK Corporate Governance Code 2010, Para B.3.3

⁶⁶² The UK Corporate Governance Code 2010, Para B.3.2

The comparative analysis of the EU suggests that the UK is strict in terms of restricting executive board mandates. Austria, for example, allows for four additional appointments for executives⁶⁶³ and Estonia allows for two.⁶⁶⁴ However, when it comes to restricting non-executive mandates, the UK approach appears to be common across the EU though some EU codes still impose restrictions or recommendations for non-executives. For example, Germany's restriction for non-executives is ten⁶⁶⁵ and it is five in France.⁶⁶⁶ It appears that some States already regard it as necessary to restrict the number of appointments held by the non-executive directors – or members of the supervisory board. However, these figures appear slightly arbitrary as it would seem unlikely that an individual would have the time to undertake ten, or perhaps even five, roles without questions being raised as to a non-executive's time commitment. The Netherlands does defend its restriction on the basis that it makes apparent to supervisory board members that they should make sufficient time available to perform their duties.⁶⁶⁷

⁶⁶³ The Austrian Code of Corporate Governance 2010, Para 25

⁶⁶⁴ Estonia Corporate Governance Recommendations, Para 2.2.2

⁶⁶⁵ The German Stock Corporation Act (AtkG), s. 100

⁶⁶⁶ The French Recommendation of Corporate Governance 2011, Part II Para D.2

⁶⁶⁷ Dutch Corporate Governance Code: Principles of good corporate governance and best practice provisions (2008) para 39